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# ADMINISTRATION'S FISCAL YEAR 1989 BUDGET PROPOSALS RELATING TO THE INTERNAL REVENUE SERVICE AND THE U.S. TAX COURT

## HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

OF THE

## COMMITTEE ON WAYS AND MEANS
## HOUSE OF REPRESENTATIVES

ONE HUNDREDTH CONGRESS

SECOND SESSION

APRIL 13, 1988

**Serial 100-70**

Printed for the use of the Committee on Ways and Means

U.S. GOVERNMENT PRINTING OFFICE

91-655 WASHINGTON : 1989

For sale by the Superintendent of Documents, Congressional Sales Office
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# ADMINISTRATION'S FISCAL YEAR 1989 BUDGET PROPOSALS RELATING TO THE INTERNAL REVENUE SERVICE AND U.S. TAX COURT

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WEDNESDAY, APRIL 13, 1988

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON OVERSIGHT,
*Washington, DC.*

The subcommittee met, pursuant to notice, at 10:03 a.m., in room B-318, Rayburn House Office Building, Hon. J.J. Pickle (chairman of the subcommittee) presiding.

[The press release announcing the hearing and background material assembled by staff follow:]

FOR IMMEDIATE RELEASE
MONDAY, APRIL 4, 1988

PRESS RELEASE #17
SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1105 LONGWORTH HOUSE OFFICE BLDG.
WASHINGTON, D.C. 20515
TELEPHONE: (202) 225-5522

THE HONORABLE J. J. PICKLE (D., TEXAS), CHAIRMAN,
SUBCOMMITTEE ON OVERSIGHT, COMMITTEE ON WAYS AND MEANS,
U.S. HOUSE OF REPRESENTATIVES,
ANNOUNCES A HEARING
TO CONSIDER THE ADMINISTRATION'S FISCAL YEAR 1989
BUDGET PROPOSALS RELATING TO THE INTERNAL REVENUE SERVICE
AND THE UNITED STATES TAX COURT

---

The Honorable J. J. Pickle, (D., Texas), Chairman of the Subcommittee on Oversight, Committee on Ways and Means, U.S. House of Representatives, announced today that the Subcommittee will hold a hearing to examine the overall adequacy of the Administration's fiscal year 1989 budget proposals relating to the staffing levels and allocation of resources for the Internal Revenue Service and the U.S. Tax Court. In addition, the Subcommittee will continue its review on the status of the 1988 tax return filing season, focusing particularly on quality and availability of taxpayer services.

The hearing has been scheduled for Wednesday, April 13, 1988, in Room B-318 Rayburn House Office Building, beginning 10:00 a.m. Witnesses expected to appear at the hearing include the Internal Revenue Service, the United States Tax Court and the U.S. General Accounting Office.

In announcing the hearing Chairman Pickle made the following statement: "This year, the Subcommittee on Oversight will again analyze the proposed budgets for the Internal Revenue Service and the United States Tax Court. We must make certain that the Internal Revenue Service has the resources necessary to fairly and efficiently administer the Federal tax system and to meet its responsibility of providing quality service to taxpayers."

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Persons submitting written comments for the printed record of the hearing should submit six (6) copies by the close of business, Friday, May 13, 1988, to Robert J. Leonard, Chief Counsel, Committee on Ways and Means, U.S House of Representatives, Room 1102 Longworth House Office Building, Washington, D.C. 20515.

SEE FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will **not** be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages.
2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.
3. Statements must contain the name and capacity in which the witness will appear or, for written comments, the name and capacity of the person submitting the statement, as well as any clients or persons, or any organization for whom the witness appears or for whom the statement is submitted.
4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and public during the course of a public hearing, may be submitted in other forms.

J.J. PICKLE, TEXAS, CHAIRMAN
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WASHINGTON, DC 20515

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BETH BUNTZ VANCE, SUBCOMMITTEE STAFF DIRECTOR

J.L. SINGLETON, MINORITY CHIEF OF STAFF
MICHAEL A. SUPERATA, COUNSEL TO THE MINORITY

April 5, 1988

The Honorable Lawrence B. Gibbs, Jr.
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Dear Commissioner Gibbs:

The Subcommittee on Oversight of the Committee on Ways and Means will hold a hearing on the Administration's Fiscal Year 1989 Budget Proposals relating to the Internal Revenue Service and the United States Tax Court.

I would appreciate your appearance as a witness at this hearing which is scheduled for Wednesday, April 13, 1988, beginning at 10:00 a.m., in room B-318 Rayburn House Office Building. Attached are a series of questions concerning the IRS's FY'89 Budget for which I would appreciate a written response by April 11, 1988. Also included for your information is the press release concerning the Subcommittee's review of this matter.

I appreciate your cooperation in preparing for this hearing. As always, I am requesting that 150 copies of your statement be delivered to 1105 Longworth House Office Building no later than 4:00 p.m. Monday, April 11, 1988. If you have any questions regarding this matter, please contact Joseph Grant, Assistant Counsel, at 225-5522.

In the meantime, I remain

Sincerely,

J. J. Pickle, Chairman
Subcommittee on Oversight

JJP/jgl

Attachments

Attachment: IRS Questions

1. The IRS sent a budget request to Treasury for 127,103 staff positions and $6.1 billion. The budget OMB submitted to the Congress requests 13,000 less positions and $870 million less in funding.

   (a) What activities will you not do under OMB's budget which you would have done under yours?

   (b) How much revenue could be brought in under your (IRS) proposal that will not be brought in under OMB's proposal?

2. How would the Service allocate additional staffing over the proposed FY 1988 levels at each of the following levels:

   (a) 500 additional staff?

   (b) 1,500 additional staff?

   (c) 3,500 additional staff?

   (d) 5,000 additional staff?

   (e) What would the yield-to-cost ratio be at each level?

3. Along with the need for the sheer number of employees, there are serious questions about the training of personnel, particularly in the area of taxpayer service, adjustments and correspondence, and examination.

   (a) Are you satisfied with the current training programs?

   (b) If not, how are you improving the training of personnel to ensure fewer errors?

   (c) Does the budget proposal allow the resources to improve in this area? Specifically, how are training resources allocated in each category and how does it compare to FY'88?

4. Looking at the trend in your examination policy over the past few years, there has been a steady decline in the percentage of returns audited from 2.1 percent in FY 1980 to the 1.1 percent for FY 1987. FY 1987 coverage rose to only 1.2% and the estimated FY'89 audit rate is projected to be 1.3%, still 40% lower (.8%) than the 1980 rate.

(a) What is the maximum number of examination staff the IRS could absorb (hire and fully train) in FY'89 and subsequent years?

(b) What returns will be audited under the proposed 1.3% rate for FY 1989 (breakdown by individuals, corporate, and breakdown by income class, size)?

(c) What activities would have been conducted had the third year of the revenue initiative been staffed and funded?

(d) Why was the revenue initiative not included in the IRS proposed budget for FY'89?

5. The FY'89 budget for Taxpayer Services is essentially unchanged from you FY'88 budget.

(a) What resources are included in your budget to allow you to improve the quality and accuracy of taxpayer services? How does this compare to FY'88?

(b) Will you maintain the same level of service you provided last year?

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D C 20224

COMMISSIONER

APR 12 1988

The Honorable J. J. Pickle
Chairman
Subcommittee on Oversight
House Ways and Means Committee
Washington, D.C. 20515-6350

Dear Mr. Chairman:

This is in response to your letter of April 5, 1988, in which you asked several questions in preparation for the hearing of April 13th.

Enclosed are our answers to Questions 1, 3, 4(a)-((c), and 5. We will provide the answers to Questions 2 and 4(d) as soon as we can obtain the necessary clearances.

If you have any questions, please contact Gayle Morin, Director of our Legislative Affairs Division, on 566-6070.

With best regards, I am

Sincerely,

Bryan Slone
Assistant to the Commissioner
(Legislative Liaison)

Enclosures

IMPACT OF ADMINISTRATION ACTIONS
ON IRS BUDGET FOR FY 1989

Question: The IRS sent a budget request to Treasury for 127,103 staff positions and $6.1 billion. The budget OMB submitted to the Congress requests 13,000 less positions and $870 million less in funding.

(1a) What activities will you not do under OMB's budget which you would have done under yours?

Answer: The Administration did reduce the IRS budget by the amounts you indicate. However, the IRS budget for 1989 as proposed by the Administration, is $241 million above the level ($5.1 billion) appropriated for this year. This represents a 4.8% increase in financial resources at a time when domestic spending overall is limited to a 2% increase under the bipartisan budget summit agreement. Moreover, the Administration has supported recommendations to redirect resources into taxpayer service and returns processing, recognizing the importance of IRS service to the public.

No major activities or programs are being reduced in this budget. IRS, like other Federal agencies, is cutting back on less essential spending, principally in support and administrative expenses, to help offset increased pay costs ($29 million).

The reductions made by the Administration to our budget proposals ($870 million) represent limits placed on the rate of program expansion or adjustments in cost factors or timing. For instance, the bipartisan summit agreement did not contemplate new revenue starts by IRS in 1989. This policy decision foreclosed, at least initially, the addition of 6,842 positions and $287 million. In taxpayer service, proposals to expand outreach, taxpayer education, and walk-in assistance were not approved (463 positions and $20 million) although the Administration did support redirecting $51 million (1500 positions) in excess retirement funds to reach an 85% level of telephone answering. IRS initially requested an increase of $369 million (+29%) for ADP and systems modernization initiatives. These proposals were scaled back to $137 million (+11%) recognizing in part delays in design and procurement. The reductions to the automated examination system ($36 million) and automated taxpayer service system ($3 million) reflect such delays. The budget request to Treasury was prepared a year ago and adjustments for timing are fairly routine. The initial budget had some design funds ($10 million) for a new headquarters building. Since the site prospectus has not yet been approved, the funds are not being requested.

The Internal Revenue Service supports the President's budget request for FY 1989.

Question: (1b) How much revenue could be brought in under your (IRS) proposal that will not be brought in under OMB's proposals?

Answer: The revenue from direct enforcement of the tax laws which would have been produced from the IRS proposed initiatives total $1.1 billion in FY 1989 and $2.2 billion in FY 1990.

QUESTION 3: Along with the need for the sheer number of employees, there are serious questions about the training of personnel, particularly in the area of taxpayer service, adjustments and correspondence, and examination.

(a) Are you satisfied with the current training programs?

(b) If not, how are you improving the training of personnel to ensure fewer errors?

ANSWER: We are constantly striving to improve and enhance our training programs in order to provide better customer service to taxpayers in meeting their tax obligations and to ensure equitable enforcement of the tax laws.

The training programs for tax assistors and service center (returns processing) personnel are reviewed and revised/updated each year -- there are about 100 courses between these two programs. In FY 1987 we completed a major revision of these programs to include changes in the tax law resulting from the Tax Reform Act.

On January 1, 1988, we provided the service centers with a training package for correspondence. We have also rewritten all the Adjustment Combination IRM/Training Packages. Although National Office provides all the training material to the centers for training, it has always been up to the centers to schedule needed training of their employees. We have also developed a Program Analysis System to assist the centers monitoring their accuracy and to analyze trends to determine where additional training is needed.

This past year the courses for Taxpayer Service assistors were redesigned to emphasize the skills necessary to provide quality service such as effective communication, probing, and courtesy. All materials were updated to reflect the Tax Reform Act of 1986 changes. We secured the services of an outside contractor to assist us in the development of special courses designed to teach how to research in Publication 17 and our Taxpayer Service manual. A contractor also developed a course on effective listening and notetaking. These special courses are mandatory for all Taxpayer Service assistors.

An outside contractor which specializes in instructional methodologies has been secured to assist us in several Taxpayer Service areas this next year. The contractor will be redesigning our tests used during our recruit training to be more reflective of classroom performance. In addition, a simulation module will be developed that will allow the trainees to practice in the classroom what they will be doing on the job. We are also developing a more sophisticated system that will improve our ability to assess the effectiveness of our training program so that remedial action can be implemented.

We have also established a Quality Improvement Project, chaired by one of our executives, to analyze the Taxpayer Service training program. The team will focus on establishing a systematic approach for conducting training that will encompass: the inputs necessary for developing a program; the reviews required to ensure effectiveness; and assessments needed to measure the effects produced by training and their impact on the organization and the public. The team will apply the Juran quality improvement process as their problem-solving model.

Recently, our Examination training programs have received considerable attention resulting in several initiatives. For example, a review of our revenue agent recruit training program was recently completed. It primarily addressed the way our new examiners will be examining tax returns. The study group is in the process of making recommendations that may be implemented with our fiscal year 1988 summer hires.

We also have completed an initiative to revise our On-the-Job training guidelines. The guidelines include newly defined goals with emphasis on the Examination Auditing Standards, and the use of experienced senior examiners to serve as training facilitators to increase the transfer of examination skills.

Presently, one of our regions is testing alternative curriculum designs for the most effective presentation of our recruit training materials.

In addition, we are gathering and evaluating training data as part of an ongoing nationwide study of revenue agents hired during fiscal years 1984 through 1987. The study is intended to identify factors contributing to the success of revenue agents from entry through the journey level of the job. Academic and experiential backgrounds, IRS classroom training tests, AICPA tests and on-the-job appraisals are being evaluated to yield indicators of successful performance. The training data being obtained will establish the strengths and weaknesses of trainees in specific subject areas as well as the strengths and weaknesses in training course content and methods.

QUESTION 3(c): Does the budget proposal allow the resources to improve in this area? Specifically, how are training resources allocated in each category and how does it compare to FY 1988?

The budget for FY 1989 included resources to provide basic recruit training for new hires. These cost estimates are updated each year to reflect inflationary cost increases and any revisions in delivery of the training courses (e.g., extension of a course from 4 to 5 weeks or addition of a new phase or unit, etc.). However, it should be noted that these estimates are developed some two years prior to the submission of our budget to the Congress and some of the improvements we are making were not considered when developing the FY 1989 budget.

Recruit training funds are allocated on a geographic basis -- that is, the distribution will match the hiring plans for that year. Other training funds are allocated by special project requirements (e.g., automation, quality, etc.). Our FY 1989 budget reflects an increase of over $11 million over FY 1988, primarily resulting from recruit training for new hires and automation projects.

QUESTION

4. Looking at the trend in your examination policy over the past few years, there has been a steady decline in the percentage of returns audited from 2.1% in FY 1980 to the 1.1% for FY 1987. FY 1988 coverage rose to only 1.2% and the estimated FY'89 audit rate is projected to be 1.3%, still 40% lower (.8%) than the 1980 rate.

a. What is the maximum number of examination staff the IRS could absorb (hire and fully train) in FY'89 and subsequent years.

b. What returns will be audited under the proposed 1.3% rate for FY 1989 (breakdown by individuals, corporate, and breakdown by income class, & size)?

c. What activities would have been conducted had the third year of the revenue initiative been staffed and funded?

ANSWER

4. a. Our maximum assimilation level for district Examination is 2,500 average positions annually.

4. b. Our proposed coverage rate of 1.27% for FY 1989 involves the proposed examination of 1,500,000 tax returns. These examinations break out as follows:

| | |
|---|---|
| Individual | |
| Non-Business (TPI) | 1,215,000 |
| Schedule C (TGR) | 159,000 |
| Schedule F (TGR) | 27,000 |
| Total Individual | 1,401,000 |
| Corporations | |
| No Balance Sheet | 2,000 |
| Assets Under $100,000 | 12,000 |
| Assets $100,000 to $1 million | 13,000 |
| Assets $1 - 10 million | 17,000 |
| Assets 10 - 100 million | 8,000 |
| Assets over $100 million | 6,000 |
| Total Corporations | 58,000 |

The remaining 41,000 examinations involve other types of tax returns.

4. c. The third year of the examination revenue initiative included a proposed 66,000 examinations, which would increase the audit coverage rate from 1.27% to 1.32%. These examinations would result in an additional $462 million in eventual collected tax.

5. Question: The FY 89 budget for Taxpayer Services is essentially unchanged from your FY 88 budget.

(a) What resources are included in your budget to allow you to improve the quality and accuracy of taxpayer services? How does this compare to FY 88?

(b) Will you maintain the same level of service you provided last year?

Answer: (a) Our FY 1989 budget includes the funding of Automated Taxpayer Service System (ATSS) in the amount of $1.9 million. This system will provide desk top computers for assistors at each toll-free telephone site and eventually at most walk-in offices. The assistors will be provided with immediate access to the Integrated Data Retrieval System (IDRS); immediate access to technical reference data; electronic competition of forms; automatic generation of management information; electronic interface with the Problem Resolution Management Information System (PROMIS) and the Centralized Inventory Distribution System (CIDS) and elimination of most paperwork processes.

Additionally, we have made a concerted effort to improve quality which includes a number of initiatives. We have established a new Branch to chart the Division's course in the areas of quality planning, measurement and improvement. One initiative established by this new Branch was to evaluate the quality and accuracy of service being provided. This system, the Integrated Test Call Survey System (ITCSS), is operating in its first phase providing quick feedback to management on accuracy rates for technical tax law inquiries. In FY 1989, plans are to set up a year-round test call system to assess the accuracy of the assistance Taxpayer Service provides in the area of account notice and refund work, as well as perfect field feedback mechanism and enhance customer relationships.

Fully utilizing all the analytical data which the ITCSS is capable of producing, we can concentrate on the areas of training improvement and targeting assistance areas at each telephone answering site in which problems have been identified.

In addition, a project prospectus was approved by the Assistant Commissioner, Taxpayer Service and Returns Processing, which began looking at quality within Taxpayer Service. The project team has since made recommendations to form three other Quality Improvement Projects.

They are Information Systems (to assess existing quality information systems and make recommendations to modify, enhance or develop information systems to provide Taxpayer Service with more useful information on the quality of service to all customers); Human Resources (comprehensive analysis of the Taxpayer Service occupation); and Training (comprehensive analysis of the Taxpayer Service training program). The three new projects have met and will be focusing on ways to improve and measure quality.

We have identified in our Strategic Business Plan that one of our major strategies is to develop a high-quality work force. The only way to increase the experience level of the Taxpayer Service work force is to maintain that work force year-after-year. In order to achieve this, we intend to increase the ratio of permanent to temporary employees and to provide incentives to stay with Taxpayer Service by increasing the grade structure. For example, to increase the mix of Taxpayer Service Specialists to Taxpayer Service Representatives. Along these lines, we are attempting to implement guidelines for reducing our managers' span of control.

(b) An 85% level of service is included in the 1989 budget and the Service is committed to achieving an 85% level of service.

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

COMMISSIONER

The Honorable J. J. Pickle
Chairman
Subcommittee on Oversight
House Ways and Means Committee
Washington, D.C. 20515-6350

Dear Mr. Chairman:

This is a follow-up to our earlier letter dated April 12, 1988. At that time we provided you with responses to all but two of the questions you raised in your April 5, 1988, letter.

Enclosed are our answers to questions 2 and 4(d). If you have any questions, please contact Gayle Morin, Director of our Legislative Affairs Division, on 566-6070.

With best regards, I am

Sincerely,

Bryan Slone
Assistant to the Commissioner
(Legislative Liaison)

Enclosures

ALLOCATION OF ADDITIONAL STAFFING
OVER FY 1988 LEVELS

Question 2: How would the Service allocate additional staffing over the proposed FY 1988 levels at each of the following levels?

a) 500 additional staff?
b) 1,500 additional staff?
c) 3,500 additional staff?
d) 5,000 additional staff?
e) What would the yield-to-cost ratio be at each level?

Answer: The President's budget, which was submitted on February 18, 1988, includes additional resources (1,650 positions and $241 million) for the Internal Revenue Service to:

-- resolve taxpayer problems (46 positions),
-- improve the quality of taxpayer correspondence (information on penalty and interest computations) issued by IRS service centers (186 positions),
-- expand efforts to detect tax fraud (127 positions), and
-- continue ADP and systems modernization efforts (758 positions),
-- handle additional tax returns resulting from growth in the taxpaying populations (489 positions net after productivity and other savings).

These resources are critical to IRS operations and represent our first priority.

In keeping with the emphasis on service and quality, our next priority is to finance those activities which serve the public. We are assessing our performance during the current filing season to determine whether resources are adequate to reach those goals. We will have to advise the Administration on this assessment. In the interim, any allocation of additional staffing beyond the President's budget represents IRS's position, not the Administration's view.

In the area of revenue-producing programs, with additional resources we would fund the third installment of the FY 1987 - FY 1989 Examination revenue initiative (3,302 positions at a cost of $147.7 million). This would further our goal of increasing audit coverage, producing additional revenue ($347 million in FY 1989; $858 million in FY 1990), and promoting voluntary compliance. It would have a revenue impact greater than the direct revenue quantified here due to the indirect compliance effects of increased audits.

We would also increase staffing in the Information Return program to help us identify those people not filing tax returns (184 average positions, $7.8 million), the Accounts Receivable program to collect taxes owed but paid (426 average positions, $17.8 million), and the Deliquent Returns program (1,088 average positions, $42.8 million). These initiatives, along with the Examination initiative, would produce additional FY 1989 revenue of $822 million and additional FY 1990 revenue of $1,773 million. Incremental levels are shown on the attached chart.

INTERNAL REVENUE SERVICE
DIRECT REVENUE PRODUCING ENFORCEMENT PROGRAMS
(Dollars in Millions)

| LEVEL OF INCREASE | AVG. POS. | COST | FY 1989 REVENUE | FY 1989 YIELD/COST | FY 1990 REVENUE | FY 1990 YIELD/COS |
|---|---|---|---|---|---|---|
| A. Examine tax returns | 529 | $23.6 | $69 | 2.9 to 1 | $172 | 7.3 to 1 |
| B. Examine tax returns | 1,321 | 59.0 | 162 | 2.8 to 1 | 402 | 6.8 to 1 |
| C. Examine tax returns | 3,302 | 147.7 | 347 | 2.3 to 1 | 858 | 5.8 to 1 |
| Match IRP information documents | 184 | 7.8 | 88 | 11.3 to 1 | 126 | 16.2 to 1 |
| Total, Level C | 3,486 | $155.5 | $435 | 2.8 to 1 | $984 | 6.3 to 1 |
| D. Examine tax returns | 3,302 | 147.7 | 347 | 2.3 to 1 | 858 | 5.8 to 1 |
| Match IRP information documents | 184 | 7.8 | 88 | 11.3 to 1 | 126 | 16.2 to 1 |
| Collect taxes owed but not paid | 426 | 17.8 | 75 | 4.2 to 1 | 125 | 7.0 to 1 |
| Secure delinquent returns | 1,088 | 42.8 | 312 | 7.3 to 1 | 664 | 15.5 to 1 |
| Total, Level D | 5,000 | $216.1 | $822 | 3.8 to 1 | $1,773 | 8.2 TO 1 |

EXAMINATION RESOURCES

Question: 4(d) Why was the revenue initiative not included in the IRS proposed budget for FY 89?

Answer: Since transmittal of the FY 1988 President's Budget, there have been major deliberations and agreements between the Executive and Legislative Branches regarding future budgets, and the FY 1988 and FY 1989 Budgets in particular. The Omnibus Budget Reconciliation Act of 1987 reflects these agreements.

- For FY 1989, the overall budget authority increase for all Federal spending on discretionary domestic programs is limited to two percent.
- The context of this two percent limitation includes agreements on outlay, deficit and revenue targets.
- It includes specific revenue initiative targets for the Internal Revenue Service in 1988 and 1989 that neither assume nor require additional funding in 1989 for the third installment of the examination initiative.
- The President's budget meets all of these targets.

The Examination revenue initiative is continued at the currently approved resource levels in FY 1989. The first two installments which total 5,502 positions and $219 million are retained.

While total domestic discretionary spending increases 2 percent above 1988 levels as required by the agreement, the IRS budget increases 4.8 percent ($241 million) to $5.3 billion. This increase covers the costs of maintaining current levels of service and selected increases to ensure that taxpayers continue to receive fully responsive service in preparing and filing their tax returns and that all refunds are processed timely.

## COMPARISON OF IRS, TREASURY AND OMB BUDGET REQUESTS

INTERNAL REVENUE SERVICE
FY 1989
Amount in thousands

| | FY 1988 AUTHORIZED | | IRS TO TREASURY | | TREASURY TO OMB | | OMB TO CONGRESS | |
|---|---|---|---|---|---|---|---|---|
| | | | TREASURY SUBMISSION | | OMB SUBMISSION | | CONGRESSIONAL SUBMISSION | |
| | Ave. Pos. | AMOUNT | Ave. Pos. | AMOUNT | Ave. Pos. | AMOUNT | Ave. Pos. | AMOUNT |
| Executive Direction | 116 | $9,877 | 137 | $9,318 | 122 | $8,686 | 116 | $8,203 |
| Management Services | 1,512 | $79,088 | 1,823 | $123,049 | 1,656 | $100,428 | 1,514 | $86,344 |
| Total Salaries & Expenses | 1,628 | $87,165 | 1,960 | $132,367 | 1,778 | $109,114 | 1,630 | $94,547 |
| Returns Processing & Revenue Accounting | 29,978 | $1,194,468 | 33,256 | $1,376,587 | 33,089 | $1,295,460 | 30,178 | $1,216,423 |
| Computer Services | 5,182 | $538,839 | 6,628 | $798,193 | 5,550 | $669,252 | 5,997 | $633,711 |
| Total Processing Tax Returns | 35,160 | $1,723,305 | 39,884 | $2,174,780 | 38,567 | $1,964,720 | 36,175 | $1,850,134 |
| Examination | 32,975 | $1,375,113 | 37,911 | $1,670,642 | 37,762 | $1,653,593 | 33,418 | $1,461,944 |
| Appeals & Tax Litigation | 5,277 | $244,824 | 5,939 | $300,605 | 5,850 | $292,323 | 5,279 | $242,497 |
| Employee Plans & Exempt Organizations | 2,903 | $121,669 | 2,971 | $120,388 | 2,964 | $126,892 | 2,925 | $121,781 |
| International | 737 | $33,992 | 942 | $50,815 | 903 | $43,379 | 790 | $38,597 |
| Total Examination and Appeals | 41,892 | $1,775,598 | 47,763 | $2,150,450 | 47,527 | $2,115,387 | 42,412 | $1,864,819 |
| Tax Fraud Investigations | 4,516 | $243,749 | 5,189 | $293,302 | 4,811 | $270,785 | 4,620 | $257,565 |
| Collection | 20,334 | $852,256 | 23,154 | $979,872 | 23,883 | $957,884 | 20,379 | $846,318 |
| Taxpayer Service | 7,206 | $382,650 | 7,637 | $350,822 | 7,197 | $316,739 | 7,174 | $309,926 |
| Enforcement Lit. & Technical | 1,425 | $74,157 | 1,516 | $89,889 | 1,587 | $85,895 | 1,421 | $76,424 |
| Total Investigation, Collection and Taxpayer Service | 33,481 | $1,472,812 | 37,496 | $1,713,885 | 36,598 | $1,629,623 | 33,594 | $1,490,225 |
| TOTAL | 112,161 | $5,058,880 | 127,103 | $6,170,682 | 124,470 | $5,818,844 | 113,811 | $5,299,725 |

Finance Division, Budget Br.
March 24 1988
E.Marr 566-4410

THE SOURCE OF THE FOLLOWING MATERIAL IS THE INTERNAL REVENUE SERVICE

1) Overall Data

INDIVIDUAL INCOME TAX RETURNS
RECEIVED AND PROCESSED

A)

Returns Received and Processed in Service Centers through March 27, 1987 and March 25, 1988. (In Thousands)

| 1. Weekly | | 1987 | 1988 | Percent Change |
|---|---|---|---|---|
| a) Receipts: | 1040 | 3508 | 3586 | 2.2 |
| | 1040A | 822 | 810 | -1.5 |
| | 1040EZ | 745 | 816 | 9.5 |
| | Total | 5075 | 5212 | 2.7 |
| b) Processed: | 1040 | 3801 | 3901 | 2.6 |
| | 1040A | 1124 | 1168 | 3.9 |
| | 1040EZ | 1072 | 1059 | -1.2 |
| | Total | 5997 | 6128 | 2.2 |
| 2. Cumulative From January | | 1987 | 1988 | Percent Change |
| a) Receipts: | 1040 | 28778 | 28752 | -0.1 |
| | 1040A | 12282 | 11648 | -5.2 |
| | 1040EZ | 11738 | 12372 | 5.4 |
| | Total* | 52798 | 52772 | -0.0 |
| b) Processed: | 1040 | 20812 | 19979 | -4.0 |
| | 1040A | 10571 | 10039 | -5.0 |
| | 1040EZ | 10626 | 11073 | 4.2 |
| | Total* | 42009 | 41091 | -2.2 |

* The prior week's cum figures plus this week's figures may not equal this week's cum figures due to service center adjustments.

REFUND COMPARISON REPORT

C)

Refunds Certified by National Computer Center through March 26, 1987 and March 24, 1988.

| 1. Weekly | 1987 | 1988 | Percent Change |
|---|---|---|---|
| a) Number (Thousands) | 5,403 | 5,809 | 7.5 |
| b) Amount of Principal (Millions) | $4,532 | $4,947 | 9.2 |
| c) Average Refund | $838.70 | $851.68 | 1.5 |
| **2. Cumulative from January 1** | | | |
| a) Number | 31,588 | 30,847 | -2.3 |
| b) Amount of Principal (Millions) | $25,127 | $25,200 | 0.3 |
| c) Average Refund | $795.45 | $816.95 | 2.7 |

2) Telephone Accuracy Rate

: U [W13] 'NATIONAL OFFICE MENU

it to Survey Menu

A B C D E F G H I J K

NATIONAL OFFICE( Individual Tax Law Inquiries
Percent Correct
Four Week Averages Through March 26, 1988

| WEEK ENDING | SER | MWR | CR | SWR | NAR | MAR | WR | NAT | CUM |
|---|---|---|---|---|---|---|---|---|---|
| OVERALL AVG. CUM.. | 75.3% | 74.8% | 75.1% | 69.7% | 66.5% | 71.8% | 70.6% | 72.0% | |
| February 13..... | 73.8% | 73.4% | 72.8% | 68.6% | 63.8% | 70.2% | 70.5% | 70.7% | 73.7% |
| 20..... | 77.2% | 73.0% | 72.2% | 67.3% | 64.8% | 70.8% | 71.8% | 71.3% | 70.8% |
| 27..... | 77.3% | 75.8% | 72.0% | 65.1% | 65.3% | 72.4% | 71.1% | 71.5% | 71.0% |
| March 5..... | 76.9% | 76.2% | 75.2% | 67.7% | 64.7% | 73.7% | 72.3% | 72.6% | 71.2% |
| 12..... | 76.6% | 76.8% | 76.9% | 71.8% | 66.7% | 71.5% | 73.4% | 73.4% | 71.4% |
| 19..... | 74.7% | 77.0% | 80.7% | 75.0% | 70.6% | 73.8% | 67.7% | 73.6% | 71.7% |
| 26..... | 73.4% | 73.1% | 80.6% | 73.9% | 73.8% | 71.1% | 66.3% | 72.5% | 72.0% |

-Apr-88 10:45 AM CMD CALC

— LETTER FROM IRS AND APPEALING —
OMB'S BUDGET

DEPARTMENT OF THE TREASURY
WASHINGTON

JAN 7 1988

ACTION

FOR: THE DEPUTY SECRETARY

FROM: Lawrence B. Gibbs
Commissioner of Internal Revenue

SUBJECT: Appeal of OMB Action on IRS Budget

I have reviewed OMB's action on our 1988 budget and 1989 budget request. The OMB passback in many ways recognizes and deals with the important issues facing tax administration. I am pleased with OMB's recognition of the need to provide proper funding to the tax processing and taxpayer service activities, particularly in view of the sweeping changes that tax reform brings. I fully support OMB's proposal to apply excess FERS funds to meet the taxpayer service need of $58 million in 1988 and to establish this funding as part of the taxpayer service base for 1989. Similarly, the allowance provides for a properly funded tax processing operation in 1988 and 1989. This is a critically important and most welcome aspect of the allowance. However, there are some significant concerns I need to bring to your attention which must be resolved.

NOTE ✳ Revenue Producing Efforts

Our FY 1989 budget proposed to continue many of the initiatives begun during the past two years and add new initiatives to collect more tax revenue. These initiatives would produce over $1 billion in additional tax revenue. It makes sense to provide IRS with funding to collect taxes already on the books that are not being paid instead of penalizing those who are already paying their fair share. The OMB allowance funds no new revenue initiatives in 1989, including the third and final installment of the Examination revenue initiative.

| | INITIATOR | REVIEWER | REVIEWER | REVIEWER | REVIEWER | SECRETARI |
|---|---|---|---|---|---|---|
| OFFICE CODE / SURNAME | Taylor | Welsh | Murphy | | | |
| INITIALS/DATE | Sent 1/7 | 1/7 | 1/7 | / | / | / |

TD F 80-02.1 (11-85)

The allowance limits staffing in the Examination program to the extent that we do not believe the budget summit revenue yield of $2.9 billion in 1989 could be met. We will need some 1,100 additional Examination FTE and $45 million to secure $415 million additional revenue needed to achieve the target.

Congress, in the Omnibus Budget Reconciliation Act of 1987 stated that "outlays for the IRS for fiscal year 1989 should be increased by $.7 billion and for fiscal year 1990 by $.8 billion... (and that) the IRS should offer improved taxpayer assistance and enforcement efforts." We believe that the Administration's budget proposal should give effect to this legislation.

OMB has also proposed that an additional $2.4 billion in revenue be scored without funding. OMB's expectations cannot realistically be met.

ADP Modernization

Our request for additional ADP and systems modernization was aimed at sustaining ongoing ADP projects such as the automation of the examination system as well as some new projects. OMB has provided the requested increases for most projects, but has either drastically cut or eliminated increases to the Counsel Automated Tracking System, Field Automation Support, Integrated Management System, and the Automated Examination System. The Counsel Automated Tracking System would provide automation tools for employees at a cost benefit ratio of more than 20 to 1, closing an additional 1,000 cases and acelerating revenue collections by $210 million in the first year of systems implementation. We are also concerned over the elimination of our nationwide office automation funding.

THE DEPUTY SECRETARY

Mandatory Increases

OMB has denied mandatory costs increases for within-grade step increases ($16.7 million), advancement of trainees ($14.3 million) and other salary deficits ($2.0 million). IRS traditionally discounts its budget for the delay in hiring and promoting employees and for filling vacancies at lower rates of pay than incumbent levels. OMB has not taken this into account.

Full absorption of this reduction would result in a loss of 1,000 jobs and $170 million in revenue collections as a majority of the cost increases occur in tax enforcement staffing.

Technical Adjustment

OMB did not provide sufficient FTE for the level of operations funded in the allowance. An adjustment of +1,286 FTE must be made to correct this.

Tax Processing: Out Years

I am concerned that staffing increases for the service centers may not be provided beyond FY 1989. We are pursuing automation initiatives such as electronic filing which we expect will reduce certain labor-intensive functions. It is, however, premature to foreclose any staffing increases at this time.

NOTE ON TAX COURT

Privatization

I have several concerns with the privatization proposal raised by OMB. Any private dispute resolution mechanism available to only those who can afford the additional costs could undermine the credibility of our

tax administration processes. The Service cannot develop regulations without the benefit of the numerous legislative changes that this proposal would require. The adoption of such a proposal without careful consideration of all of the policy ramifications, and the necessary advance consultation with the Tax Court, the Tax Bar, the professional accountants, the Justice Department and others, will result in a proposal that is neither workable nor desirable for the taxpaying public.

* Summary

We are providing detailed information in the format prescribed. In summary, we propose that you appeal 8,289 FTE and $365 million. This will result in more equitable tax administration and increase direct enforcement revenues by $1.4 billion. I will be available at your convenience to discuss with you any specifics of our appeal.

Attachments

BUREAU APPEALS

INTERNAL REVENUE SERVICE
PERSONNEL COMPENSATION
FY 1989 OMB PASSBACK
(DOLLARS IN MILLIONS)

| | 1989 | | | |
|---|---|---|---|---|
| | Request | OMB Allow. | Reduct. | Appeal Increm. |
| BUDGET AUTHORITY | $42.622 | $9.620 | $33.002 | $33.002 |
| FTE | 0 | 0 | 0 | 0 |

The personnel compensation cost increases include resources for within-grade increases ($16.7 million), advancement of trainees ($14.302 million), and Tax Fraud average salary deficit ($2 million). These increases are mandatory and must be covered by reducing staffing if funding is denied.

IRS traditionally discounts its budget submission for the delay in hiring and promoting employees and for filling vacancies at lower rates of pay than incumbent levels. In the budget, IRS has already discounted its permanent salaries (object class 11.1) in FY 1989 by $134,850,000 (5.7%).

Full absorption of this reduction would result in the loss of 1,000 jobs and $170 million in revenue collections since most of the cost increases are required in tax enforcement.

SUMMARY OF BUDGET ESTIMATES
IRS OPERATING ACCOUNTS - RESOURCE SUMMARY

| | OMB Submission | | OMB Allowance | | OMB Action | | IRS Appeal | |
|---|---|---|---|---|---|---|---|---|
| | FTE | Amount (Millions) | FTE | Amount (Millions) | FTE | Amount (Millions) | FTE | Amount (Millions) |
| FY 1988 PRESIDENT'S BUDGET (as amended) | 110,755 | $5,051.9 | 110,661 | $5,051.9 | (94) | $0.0 | | |
| FY 1988 Redirection (FERS etc..) | 3,748 | $57.8 | 1,500 | $7.0 | (2,248) | ($50.8) | | |
| REVISED FY 1988 LEVEL | 114,503 | $5,109.7 | 112,161 | $5,058.9 | (2,342) | ($50.8) | 0 | $0.0 |
| FY 1989 Adjustments: | | | | | | | | |
| Non-recurring/reductions | (2,883) | ($110.2) | (1,222) | ($285.9) | 1,661 | ($175.7) | | |
| Mandatory Increases | 1,130 | $276.0 | 662 | 302.9 | (468) | $26.9 | 468 | $57.0 |
| Workload Increases | 818 | $34.8 | 0 | $34.8 | (818) | $0.0 | 818 | |
| Workload Reductions | (286) | ($6.3) | (286) | ($6.3) | 0 | $0.0 | | |
| Service Center Base Deficiency | 3,044 | $47.9 | 3,044 | $39.2 | 0 | ($8.7) | | |
| Revenue Initiatives | 6,842 | $286.6 | 0 | $0.0 | (6,842) | ($286.6) | 6,842 | $286.6 |
| Other Initiatives | 403 | $16.9 | 403 | $14.9 | 0 | ($2.0) | | $2.0 |
| ADP Modernization | 899 | $163.5 | 758 | $91.3 | (141) | ($72.2) | 81 | $19.6 |
| TOTAL, IRS | 124,470 | $5,818.9 | 115,520 | $5,249.8 | (8,950) | ($569.1) | 8,209 | $365.2 |

BUREAU APPEALS

INTERNAL REVENUE SERVICE
EXAMINATION
FY 1989 OMB PASSBACK
(DOLLARS IN MILLIONS)

REVENUE INITIATIVE

| | 1989 | | | |
|---|---|---|---|---|
| | Request | OMB Allow | Reduct. | Appeal Increm. |
| BUDGET AUTHORITY | $147.700 | $ 0 | $147.700 | $147.700 |
| FTE | 3,302 | 0 | 3,302 | 3,302 |

The Administration has placed a high priority on enforcing and encouraging compliance with the tax laws as evidenced by the President's Grace Commission's recommendation that the Service increase staffing by 2,500 staff-years per year from FY 1987 - 1989. The passback does not provide funding to achieve the objectives of identifying and correcting areas of non-compliance. 1,106 FTE and $45.8 million must be restored in FY 1989 to ensure that the negotiated settlement of $2.9 billion (net) be achieved. Failure to do so would result in a FY 1989 revenue loss of $416 million and a reduction of the negotiated settlement to $2.5 billion (net). Without FY 1989 Revenue Initiative staffing, there will be:

- a loss of 95,000 examinations in FY 1989.
- a loss of $610 million in collected tax, penalties, and interest in FY 1989.
- a loss of $5.263 billion in ultimately collected tax, penalties and interest through FY 1993.

BUREAU APPEALS

INTERNAL REVENUE SERVICE
EXAMINATION
FY 1989 OMB PASSBACK
(DOLLARS IN MILLIONS)

Service Center Examination TEFRA Initiative

| | 1989 | | | |
|---|---|---|---|---|
| | Request | OMB Allow | Reduct. | Appeal Increm. |
| BUDGET AUTHORITY | $14.410 | $0 | $14.410 | $14.410 |
| FTE | 634 | 0 | 634 | 634 |

The Administration has placed a high priority in the closing of tax shelter and non-tax shelter partnership/shareholder type returns through the legislation of both the TEFRA, and Subchapter S Revision Acts, of 1982. Service Center resources have been converted to TEFRA work to meet this need. Without this staffing, regular service center contacts will suffer. There will be:

- a loss of $179.6 million per year collected tax and penalties.

As significant as the loss in revenue, however, is the deleterious effect the passback has on the Service's presence, since this initiative concentrates on examining and correcting high volume returns. Without funding, there will be a loss of 244,200 contacts.

BUREAU APPEALS

INTERNAL REVENUE SERVICE
COLLECTION ACCOUNTS RECEIVABLE INITIATIVE
FY 1989 OMB PASSBACK
(DOLLARS IN MILLIONS)

| | 1989 | | | |
|---|---|---|---|---|
| | Request | OMB Allow | Reduct. | Appeal Increm |
| BUDGET AUTHORITY | $22.329 | $0 | $22.329 | $22.329 |
| FTE | 533 | 0 | 533 | 533 |

We are appealing the entire disallowance of this initiative. Without this initiative, Collection will not be able to dispose of over 59,000 accounts and collect over $94.1 millionin FY 1989. Collecitons from this initiative would increase to $127 million in FY 1990. Delinquent account inventories would rise to over three million cases with a value of $16 billion in FY 1989. Failure to collect the taxes due may erode public confidence in the fairness of the tax system and reduce future compliance. Included in the appeal amount are $1.235 million and 33 FTE for follow on and support in Appeals and Tax Litigation and Returns Processing. These resources are required to complete cases started by this initiative.

91-655 O - 89 - 2

BUREAU APPEALS
INTERNAL REVENUE SERVICE
DELINQUENT RETURNS COMPLIANCE INITIATIVE
FY 1989 OMB PASSBACK
(DOLLARS IN MILLIONS)

| | 1989 | | | |
|---|---|---|---|---|
| | Request | OMB Allow. | Reduct. | Appeal Increm. |
| BUDGET AUTHORITY | $86.278 | 0 | $86.278 | $86.278 |
| FTE | 2,018 | 0 | 2,018 | 2,018 |

Collection is appealing the entire amount disallowed, since it impacts on three interrelated programs. We will not be able to expand the Special Compliance Program, Returns Compliance Program, and BMF Delinquent Returns Program without this initiative. Our Special Compliance Program focuses on three areas: employment tax examinations, offshore tax haven and money laundering operations, and incorrect and fraudulent Form W-4. Our Returns Compliance Program emphasizes locally identified areas of non-compliance and national programs to identify self-employed taxpayers who are not filing required returns. Our BMF Delinquent Returns Program concentrates on business taxpayers which have not filed required returns.

In particular, we are concerned about the negative impact the loss of this initiative will have on our programs to identify and investigate tax non-compliance among targeted areas of the populace. As part of its Strategic Initiatives, the Internal Revenue Service is attempting to improve compliance among self-employed taxpayers. Collection is participating by developing Returns Compliance leads in this area. Our Tracking Receipts and Currency Exchanges (TRACE) project investigates taxpayers who use offshore banking to avoid payment of taxes. Many of these taxpayers are involved in narcotics trafficking and other illicit activities. Without this initiative, neither type of investigation will be possible.

Without this increase, we will be unable to work 114,000 cases (including 74,000 Taxpayer Delinquency Investigations) in 1989. This will result in decreased assessments of $795 million and decreased collections of $408 million in FY 1989. All phases of the Delinquent Returns Program increase current and future yield. Our balanced enforcement approach requires that we maintain an equilibrium between the accounts receivable and delinquent returns programs. Timely identification of non-compliance and implementation of corrective action by the Internal Revenue Service improves future compliance by these and other taxpayers. Future yield is thus increased at no additional cost.

Included in the appeal amount is $29.229 million and 666 FTE for follow-on and support in such functions as Appeals & Tax Litigation, Criminal Investigation, and Accounts Receivable. These resources are required to complete the cases started by this initiative.

BUREAU APPEALS

INTERNAL REVENUE SERVICE
COLLECTION (IRP) NONFILER INITIATIVE

FY 1989 OMB PASSBACK
(DOLLARS IN MILLIONS)

| | 1989 | | | |
|---|---|---|---|---|
| | Request | OMB Allow. | Reduct. | Appeal Increm. |
| BUDGET AUTHORITY | $7.774 | 0 | $7.774 | $7.774 |
| FTE | 184 | 0 | 184 | 184 |

Collection is appealing the entire amount disallowed. We will not be able to expand the Nonfiler (IRP) Taxpayer Delinquency Investigation (TDI) Program without this initiative. This program identifies taxpayers who have not filed individual income tax returns for two preceding years, and who, according to information returns filed by payers, have sufficient income to generate a tax liability. Collection then attempts to secure the return through correspondence and field contacts, or, if sufficient information exists, prepares a Substitute for Return (SFR) if the taxpayer does not voluntarily file.

Without this increase, we will be unable to work 55,000 TDI's in 1989. This will result in decreased assessments of $171 million in FY 1989. The Nonfiler TDI Program increases current and future yield. Timely identification of non-compliance and implementation of corrective action by the Internal Revenue Service improves future compliance by these and other taxpayers. Future yield is thus increased at no additional cost.

BUREAU APPEALS

INTERNAL REVENUE SERVICE

FY 1989 OMB PASSBACK
(DOLLARS IN MILLIONS)

INTERNATIONAL COMPLIANCE PROGRAMS

| | 1989 | | | |
|---|---|---|---|---|
| | Request | OMB Allow. | Reduct. | Appeal Increm. |
| BUDGET AUTHORITY | $6.6 | 0 | $6.6 | $6.6 |
| FTE | 116 | 0 | 116 | 116 |

Compliance by U.S. taxpayers abroad is generally conceded to be much lower than that of taxpayers living within the U.S. In a 1986 survey, GAO estimated that as many as 61% of American taxpayers residing abroad may not be filing required tax returns. This initiative is designed to improve compliance programs aimed at overseas taxpayers and is in keeping with the Five Year Resource Plan (FY 1988-FY 1992) submitted by the Commissioner to the House Appropriations Committee in April 1987. International Tax Administration was one of three special compliance problems determined to need attention in that plan. Also, Congressman Dorgan's task force on the tax gap, in a report issued in April 1987, recommended that IRS expand its current programs to locate overseas non-filers and to expand its efforts in overseas enforcement.

Failure to receive funding in this area will:

- compromise the ability of the service to improve the the operational effectiveness of the Foreign Information Returns Program (FIRP), which is one of the primary means to detect unreported foreign source income from overseas.
- eliminate the Service's plan to increase international enforcement efforts by hiring additional revenue agents, revenue officers and special agents. The revenue impact is $27 million in the Examination program and $15 million in Collection programs.
- reduce the Service's efforts to research the cause and extent of the international compliance problem, and delay the development of programs intended to combat this problem.

BUREAU APPEALS

INTERNAL REVENUE SERVICE
DATC/ASTA TAXPAYER IDENTIFICATION
NUMBER FOR DEPENDENTS INITIATIVE
FY 1989 OMB PASSBACK
(DOLLARS IN MILLIONS)

| | 1989 | | | |
|---|---|---|---|---|
| | Request | OMB Allow. | Reduct. | Appeal Increm. |
| BUDGET AUTHORITY | $1.540 | 0 | $1.540 | $1.540 |
| FTE | 55 | 0 | 55 | 55 |

This initiative is required to implement a provision of the Tax Reform Act of 1986 requiring Taxpayer Identification Numbers for dependents on returns claiming dependents over the age of five. These resources are requested to process approximately 250,000 returns to determine taxpayer compliance. In addition to the expected compliance impact of this initiative, it is expected that $25 million in FY 1989 revenue will be generated.

BUREAU APPEALS

INTERNAL REVENUE SERVICE
ENTRY CONTROL SYSTEM
FY 1989 OMB PASSBACK
(DOLLARS IN MILLIONS)

| | 1989 | | | |
|---|---|---|---|---|
| | Request | OMB Allow. | Reduct. | Appeal Increm. |
| BUDGET AUTHORITY | $2.005 | 0 | $2.005 | $2.005 |
| FTE | 0 | 0 | 0 | 0 |

The Entry Control System (ECS) will automate the screening of personnel entry at our major computer facilities, which is currently performed by contract guards. We estimate that it will reduce the number of required guard service hours by 11 to 27 percent, depending upon the site. Since guard service costs have been increasing at a rate of up to 20.5% per year, ECS will not reduce future costs of guard service costs but will substantially reduce inflationary costs.

Because of the time needed to develop contract specifications, award the contract, complete construction, and install, test, and accept the system, realization of savings will not occur until about two years after funding approval has been received.

Failure to fund ECS in FY 1989 will mean that the Service will lose over $950,000 in savings to the cost of guard services beginning with FY 1991. This savings will increase each year proportionate to the escalation of guard service costs.

BUREAU APPEALS

INTERNAL REVENUE SERVICE
ADP AND SYSTEMS MODERNIZATION
AUTOMATED EXAMINATION SYSTEM
FY 1989 OMB PASSBACK
(DOLLARS IN MILLIONS)

| | 1989 | | | |
|---|---|---|---|---|
| | Request | OMB Allow. | Reduct. | Appeal Increm. |
| BUDGET AUTHORITY | $29.516 | $1.014 | $28.502 | $4.000 |
| FTE | 60 | 0 | 60 | 0 |

When the FY 1989 budget was prepared, the contract award for the mini/micro phase of AES was scheduled for April, 1988. Thus, FY 1989 would have been the first full year under the contract. The award date is now estimated at June, 1989. As a result, funds for this purpose will not be required.

A substantial portion of the maintenance contract increases are affected similarly. However, maintenance and other increases for additional hardware acquired in FY 1988 are estimated to require $4.0 million above the amount allowed. The restoration of these funds is requested. (The additional hardware comprises desktop computers for large case and review staffs, as well as advance technology portable computers for high density metropolitan areas and handicapped employees.)

Productivity improvements in FY 1987 were less than originally projected because of implementation delays. However, we believe additional revenues of $63 million were gained through the system -- and these will continue to grow as system components are set in place. Improved examiner efficiency is resulting from the system. To accelerate delays in benefits from the mini/micro phase, an interim plan has been devised which will place desktop computers and advanced technology portables in large case and other specialized revenue agent groups. This plan will reduce the learning curve of the mini/micro phases and achieve a portion of the benefits now delayed because of the TMAC contract award.

The total $4.0 million appeal amount is to maintain current levels. No funds are being appealed for program increase.

BUREAU APPEALS
INTERNAL REVENUE SERVICE
ADP AND SYSTEMS MODERNIZATION
FIELD AUTOMATION SUPPORT
FY 1989 OMB PASSBACK
(DOLLARS IN MILLIONS)

| | 1989 | | | |
|---|---|---|---|---|
| | Request | OMB Allow | Reduct. | Appeal Increm. |
| BUDGET AUTHORITY | $30.748 | $ 0 | $30.748 | $30.748 |
| FTE | 5 | 0 | 5 | 5 |

- Of the total requested increase, $11.529 million has been reapplied from other Appropriations in the budget to Appropriation II. These resources fund existing office automation equipment in the Field and were simply reapplied to this initiative. These funds already exist within our budget base. In addition, $5.489 million in annualization costs are needed to fund the full year cost of the equipment that will be installed in FY 1988.

- The remaining $13.730 million is necessary to begin replacement of technologically obsolescent equipment that was procured in the early 1980's under the first Mini/Micro Requirements Contract. The mini and micro computers directly and/or indirectly support Service programs and projects by making end-user computing available for performing a wide variety of tax processing related functions. This allows Service personnel the opportunity to increase their productivity as they maximize their efficiency. With improvements in technology, small scale systems are able to handle applications that were previously performed on larger mainframes. Funding is needed to allow the Service to accrue the benefits from the newer technology. New procurement vehicles via the Departmental Microcomputer Acquisition Contract (DMAC) and the Treasury Multiuser Acquisition Contract (TMAC) will be in place so that the Service can replace the existing equipment that is fast approaching obsolesence and becoming more costly to maintain.

- Failure to provide the resources requested for replacing the current systems via TMAC and DMAC would result in increasing hardware and software maintenance costs for the existing equipment. The maintenance costs for the zilogs alone are expected to be $15 million in FY 1989 under a new maintenance contract. If the systems are not replaced, it will cost more to maintain the old ones than to procure new equipment. In addition, many revenue, enforcement and related programs would be negatively impacted due to their dependence on the small scale systems supported by this initiative.

- Of the total $30.748 million appeal, $19.378 million is to maintain current levels and 5 FTE and $11.370 are for program increases.

BUREAU APPEALS

INTERNAL REVENUE SERVICE
ADP AND SYSTEMS MODERNIZATION
INTEGRATED MANAGEMENT SYSTEM
FY 1989 OMB PASSBACK
(DOLLARS IN MILLIONS)

| | 1989 | | | |
|---|---|---|---|---|
| | Request | OMB Allow | Reduct. | Appeal Increm. |
| BUDGET AUTHORITY | $3.955 | $2.000 | $1.955 | $1.955 |
| FTE | 90 | 24 | 66 | 66 |

If we are required to absorb such a cut, we would be unable to continue with the Integrated Management System (IMS) Pilot being developed at the Philadelphia Service Center.

IMS is crucial to the IRS' ability to manage its service center inventories and limited resources efficiently. Close tracking of upfront costs/inventories/resources will enable service center management to reduce costly (both in terms of dollars and time) end-of-processing corrections and thus permit a better product to the ultimate customer--the taxpayer. The Commitment to Quality Service initiative (CQS-5) addresses the need to modify existing information systems to incorporate and track quality factors.

IMS interfaces with several systems including PERMITS. However, PERMITS is primarily a personnel system dealing with human resources, while IMS is an information management system. IMS is designed to be an integral part of various automated information systems such as Automated Underreporter System, Automated Examination System, Integrated Collection System and Electronic Filing System. We would also like to point out that IMS is a preliminary phase of the Service Center Departmental System being developed for the 1990's.

Included in the appeal of $1.995 million is $.523 million that is being reapplied from IRS Federal Archives and Record Center (FARC) Data Link (DR-26) to the Integrated Management System (DR-27). This reapplication was done in order to consolidate two related initiatives and is to maintain current levels. The balance of the appeal, 66 FTE and $1.432 million is related to program increases.

BUREAU APPEALS

INTERNAL REVENUE SERVICE
ADP AND SYSTEMS MODERNIZATION
COUNSEL AUTOMATED TRACKING SYSTEM (CATS)
FY 1989 OMB PASSBACK
(DOLLARS IN MILLIONS)

| | 1989 | | | |
|---|---|---|---|---|
| | Request | OMB Allow | Reduct. | Appeal Increm |
| Budget Authority | $10.125 | $3.230 | 6.895 | $6.895 |
| FTE | 10 | 0 | 10 | 10 |

The requested program increase of $10.0 million and 10 staff years for CATS represents the first year of "full funding" for Chief Counsel's new information systems initiative. Proposed reductions of 10 staff years and $6.770 million were explained, in part, by the fact that Counsel has not yet completed the requirements analysis package for CATS and may be unable to obligate the full amount requested in FY 1989. Although the requirements analysis must be completed before final decisions can be made on the total systems architecture, preliminary analyses clearly point to a distributed system that will include personal computer workstations for all employees.

Current plans for FY 1989 involve nearly four million dollars in lease-to-purchase of multi-user systems from TMAC. Our contingency plan (if there are delays in awarding TMAC) is to accelerate PC purchases from DMAC. At present, fewer than one fifth of Counsel's 6,000 employees are equipped with personal computers. Such hardware acquisitions are perfectly consistent with our long range strategy of providing automation tools to attorneys, appeals officers, paralegals, and support staff. Our contingency plan will still provide for productivity gains in FY 1989 through increased access to case tracking systems, improved legal research, and enhanced word processing capabilities.

Initial benefit/cost analysis indicates a benefit/cost ratio of more than 20:1. Productivity increases projected for the first full year of system implementation will result in 1,000 additional case closings and accelerated revenue collections of approximately $210 million.

In FY 1988, Counsel had ADP equipment costs totalling $2.859 million and support costs of $582,000. The estimated $126,000 for contractual increases is needed to maintain current levels of service.

The appeal increment of 10 FTE and $6.895 million includes $.125 million to maintain current levels and the balance of the appeal, 10 FTE and $6.770 million, is for program increases.

BUREAU APPEALS

INTERNAL REVENUE SERVICE
TECHNICAL ADJUSTMENTS - FTE
FY 1989 OMB PASSBACK
(DOLLARS IN MILLIONS)

| | 1989 | | | |
|---|---|---|---|---|
| | Request | OMB Allow | Reduct. | Appeal Increm |
| BUDGET AUTHORITY | $28.721 | $28.721 | $0 | $0 |
| FTE | 1,286 | 0 | 1,286 | 1,286 |

The passback includes a number of adjustments in which cost requests were allowed without FTE staffing: RPA workload increases (726 FTE); Tax Reform (92 FTE); Employment Category Changes (223 FTE); and ADP reapplication (245 FTE). The dollars received for these functions require the FTE to achieve the workload associated with processing additional tax returns, continuing tax reform implementation, carrying out Examination and Collection workplan adjustments, and implementing ADP initiatives. The use of overtime is not a viable alternative to the 1,286 FTE.

THE DEPUTY SECRETARY OF THE TREASURY
WASHINGTON

January 8, 1988

Dear Jim:

This responds to OMB's decisions associated with the Department of the Treasury's proposed budget for FY 1989. I appreciate the consideration given to the Department's request and recognize the difficult choices which you must confront. However, there are some issues which we wish to appeal. Key matters of concern to the Department include:

- Multilateral Development Banks -- Insufficient resources were provided to cover the Administration's commitments to seek the necessary funding according to replenishment agreements. Although the arrearages represent $404.9 million in budget authority, they would entail a maximum of $62.5 million in outlays in FY 1989. In addition, as discussed with Wayne Arny, we may propose that the U.S. Government participate in the extended Structural Adjustment Facility of the IMF at $15 million a year for ten years starting in 1989. We are in the middle of making the decision to participate and will do so momentarily.

- Bureau Programs -- A number of program initiatives are being appealed for the Internal Revenue Service, Law Enforcement, and Fiscal Services and Banking bureaus. Specifically, these appeals ensure the Department's law enforcement and protective functions and enable the Secretary to effectively manage the Nation's finances. Precise amounts appealed for these items are included in the enclosures.

- Pricing Adjustments to "Maintain Current Levels" (MCLs) -- The Department is labor-intensive: over 60 percent of its costs are salaries and benefits. Historical data indicates that personnel costs for the Department have risen between 1981 and 1987. We are appealing for $86.7 million out of the $188 million denied by OMB for maintaining current levels of operations in both pay and non-pay categories.

- FY 1989 Pay Raise Costs -- Full absorption of a 1989 pay raise would require reduction in basic services and programs. To prevent such reductions, $61 million is requested for the Department to cover a portion of the total estimated costs of a 2 percent pay raise in 1989.

NOTE o Revenue Issues -- Treasury will lose $.4B in revenue resulting from diminished FY 1989 examination resources. OMB's expectation that Treasury score an additional $2.6B in revenue with no change in base resources, when associated with this actually diminished resource base, results in a $3.0B disparity between Treasury and OMB revenue expectations. Finally, insufficient resources were provided for revenue producing initiatives. Treasury believes that at least one of these initiatives, service center tax examiners ($120M net revenue increase), is not only essential, but consonant with OMB's focus on efficient and productive service center operation.

The Department is appealing only those items that are essential to carrying out its functions in Fiscal Years 1988 and 1989. Our requested appeals are offset by a combination of reduced outlays and increased revenues.

Specific appeals by bureau are enclosed for your review and consideration.

Sincerely,

M. Peter McPherson

The Honorable James C. Miller III
Director
Office of Management and Budget
Washington, D.C. 20503

Enclosures

OMB PASSBACK

EXPLANATION OF DEPARTMENTAL APPEAL

Bureau: Internal Revenue Service

FY 1988

No Appeal.

FY 1989

The appeal level is $5,414.8M and 117,058 total FTE, which is an increase of $165.0M and 2,578 FTE over the OMB allowance, and includes:

$52.4M for MCLs, to allow IRS to address the net cost increase of all required personnel actions for current staffing, OPM-required advancement of trainees, and ADP functions,

$45.8M and 1,106 FTE to restore examination resources to the original FY 1988 appropriated level, allowing IRS to collect $.4B of projected enforcement revenues,

$52.4M for the January 1989 pay raise, to avoid a 1,600 position staff reduction,

$14.4M and 634 FTE for service center tax examiners, to allow IRS to collect $134M in additional revenue ($120M net), and consistent with OMB's focus on efficient and productive service center operation,

818 FTE in lieu of overtime requirements in tax processing, taxpayer service, and enforcement, which primarily reflects an increase in the projected number of returns filed, and

20 FTE for transfer of guard service responsibility from GSA for the National Computer Center, per OMB's prior approval.

Other Issues:

The Department appeals the May 1988 date for which IRS was directed to develop regulations permitting certain taxpayers to resolve tax liability disputes at their expense through private sector alternative dispute resolution processes. Numerous policy, procedural and legal issues concerning privacy, conflict of interest, and the legal standing of private rulings must be resolved. The Department requests a date of October 1988 to submit a report to OMB describing the feasibility of this proposal.

Bureau: Internal Revenue Service (continued)

The Department appeals the October 1, 1988 date by which IRS was directed to develop and put in operation an improved system to track budget execution. A pilot system will be completed by October 1, 1988. Current milestones as presented in the FY 1989 OMB Budget Submission call for this system to be fully operational by October 1, 1989. The Department appeals for a revised completion date of October 1, 1989.

A cost and benefit analysis supporting the Field Automation Support initiative will be submitted shortly after the appeal process is completed.

The OMB direction includes an increased use of overtime by service center personnel in the processing of returns. Treasury is concerned that this practice may result in increased error rates in the processing cycle, and, subsequently increased workloads for the service center error resolution activities.

The Department has strong concerns about the scoring of revenue for FYs 1990 through 1994 from the Automation of Criminal Investigation initiative. These concerns involve potential "double counting" of revenues from this system. However, the Department is willing to work with OMB to develop accurate methods to score these revenues.

DEPARTMENT OF THE TREASURY
WASHINGTON

JAN 22 1988

FOR: THE DEPUTY SECRETARY

FROM: Lawrence B. Gibbs
Commissioner of Internal Revenue

SUBJECT: Examination Revenue Initiative

I am concerned about the intention of the Office of Management and Budget to exclude the third and final installment of the Examination Revenue Initiative from the President's proposed budget for FY 1989. This would seriously undermine the Administration's credibility.

NOTE:

The Examination Revenue Initiative has been cited in the President's budget since 1986. In the FY 1986 budget, the initiative was described as follows:

> In 1986 the Internal Revenue Service will begin initial phases of an initiative to close the gap between taxes owed and paid, and to improve overall compliance with the tax laws. Based on a Grace Commission (President's Private Sector Survey on Cost Control) recommendation, examination staffing will be increased by 2,500 full-time equivalent personnel in each year, 1987-89. Advance hiring will begin in 1986. Receipts are estimated to increase by $0.5 billion in 1987 and $1.5 billion in 1988 as a result of this initiative.

In testimony before the House Subcommittee on Appropriations last spring, Secretary Baker said that "our second objective is to strengthen the capability of the IRS to promote tax compliance and generate revenue. In FY 1988, we are requesting funds for the second of a major revenue initiative begun in FY 1987." Later, in the same hearing, he stated:

> The IRS budget also funds the second phase of the FY 1987-1989 Examination Revenue Initiative, which will permit the IRS to collect an additional $443 million in FY 1988 and $5.9 billion by FY 1992.

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THE DEPUTY SECRETARY

Former Commissioner Egger and I have referred to the Examination Revenue Initiative in each appearance made before the Senate and House Appropriation Subcommittees during the last three years. In his remarks regarding the FY 1987 budget, former Commissioner Egger noted that "the cornerstone of the budget is a major revenue initiative. The proposal calls for annual increments of 2,500 examination staff for three years, beginning in fiscal year 1987." It is my recollection, that Director Miller also testified on behalf of a three year initiative to examine more tax returns.

I appreciate your support of this initiative. I am available to assist you in obtaining Administration support.

Chairman PICKLE. The subcommittee will come to order.

Good morning, everyone. This morning, the Subcommittee on Oversight is considering the adequacy of the administration's proposed fiscal year 1989 budget for the Internal Revenue Service. Each year, this subcommittee, in conjunction with the full Committee on Ways and Means and the Appropriations Committee, undertakes this review. I think this is the fifth time this subcommittee has done this. Our goal is to ensure that the Internal Revenue Service is being properly managed, and receiving the resources needed to maintain the high standards of quality essential to administering the tax laws.

This budget review is important because, more than any other Federal agency, the Internal Revenue Service affects the lives of every citizen. The Internal Revenue Service is charged with everything from rapidly processing the smallest tax refund, to thoroughly examining the most complex business return. And, of course, the Service must collect nearly $1 trillion this year to finance our Federal Government. All of this depends on the ability of the Service to function efficiently and effectively.

This year's budget review is especially important because it comes at a time when the Internal Revenue Service is facing enormous legislative and administrative changes. Almost every year, since 1980, the administration and the Congress have supported legislation making major changes in our tax laws. At the same time, the Service is in the middle of reorganizing its entire system of tax administration. This effort will include a complete redesign of the Service's computer systems.

These reforms have been undertaken amidst great publicity and considerable controversy. They will directly or indirectly affect every taxpayer. And while the public is uncertain about how all these changes will affect them, they suspect the worst. It is no exaggeration to say that public support for our voluntary tax system depends on the Internal Revenue Service's implementation of these changes. I know that Commissioner Gibbs agrees and shares these same concerns.

I personally am concerned, however, that under the pressure of an ever rising volume of returns, refunds, and correspondence, the quality of the Service's work will suffer, and that needed tax initiatives will be canceled or delayed. Furthermore, earlier this year this subcommittee received testimony raising grave concerns about the quality of information given to taxpayers calling the Service for taxpayer assistance. I look forward to following up on this issue today, but I must say that I am disturbed because I do not see how this problem will be corrected, at least under the administration's proposed budget.

It is my hope that we might find better ways to address these problems. I thank all of the witnesses who will be testifying before the subcommittee today. Your assistance is very much appreciated, and your remarks will be fully considered.

Now, before we proceed, let me ask Mr. Schulze if he has any opening statement to make.

Mr. Schulze?

Mr. SCHULZE. Thank you, Mr. Chairman. I am pleased to join you in opening today's hearing on the fiscal year 1989 budget for the Internal Revenue Service.

The IRS is expected to collect $910 billion in tax revenue in fiscal year 1989, net after refunds. It will do this by processing 191 million primary tax returns. In addition, it will touch over 64 million taxpayers through its various taxpayer service programs.

It is difficult to underestimate the scope and importance of the IRS in the Federal Government. It is Commissioner Gibbs' responsibility to manage an agency with about 114,000 staff positions and a $5.3 billion budget for fiscal year 1989. His management and leadership is essential for the IRS to carry out its duties efficiently.

Today, the Commissioner will give us a detailed description of how he has deployed his personnel and his budgetary resources. We will be interested to learn how he has balanced his resources among competing demands of processing returns, examination and audit, collection and taxpayer service.

The subcommittee also should receive an updated progress report on the 1988 tax filing season. At our February 23 hearing, it appeared that the pace of filing returns was noticeably slower than prior years. Whereas, the amount of an average refund was noticeably higher. I am interested to learn if these unusual early results have evened themselves out as we get closer to April 15.

Also, the Commissioner might give us his opinion on how many requests for an extension to file he anticipates later this week.

Mr. Chairman, the effective management of the IRS staff and budget is essential to a smooth, efficient tax administration. I look forward to today's testimony on how we can maximize the productivity of IRS resources.

Thank you.

Chairman PICKLE. Thank you, Mr. Schulze.

Now, our first witness will be, as usual, the IRS Commissioner, who we are anxious to hear from the Honorable Lawrence Gibbs.

Mr. Gibbs, will you take your seat at the witness table along with such other witnesses or personnel that you might bring with you. You might identify the people at the table with you, Mr. Commissioner.

**STATEMENT OF HON. LAWRENCE B. GIBBS, JR., COMMISSIONER OF INTERNAL REVENUE, U.S. DEPARTMENT OF THE TREASURY, ACCOMPANIED BY MICHAEL MURPHY, SENIOR DEPUTY COMMISSIONER; JOHN WEDICK, DEPUTY COMMISSIONER FOR PLANNING AND RESOURCES; WILLIAM N. NELSON, CHIEF COUNSEL; AND CHARLES BRENNAN, DEPUTY COMMISSIONER FOR OPERATIONS**

Mr. GIBBS. Thank you, Mr. Chairman, and good morning.

Chairman PICKLE. Good morning to you.

Mr. GIBBS. I am pleased to be here this morning to talk to you and the other subcommittee members about the 1988 filing season and also about our 1989 budget.

I would like to begin by introducing my colleagues. To my left and your right is Senior Deputy Commissioner Mike Murphy

Chairman PICKLE. Mr. Murphy, good morning.

Mr. MURPHY. Good morning.

Mr. GIBBS. To Mike's left, John Wedick, our Deputy Commissioner for Planning and Resources. And to my right and your left, Will Nelson, our Chief Counsel; and to Will's right, Charlie Brennan, our Deputy Commissioner for Operations.

Chairman PICKLE. We are pleased to have all of you gentlemen here.

Mr. GIBBS. I would really like to break my testimony this morning into two pieces, one, to give you an update on the 1988 filing season, with 2 days to go, and then, secondly, to also cover our 1989 budget.

I think perhaps the best way that I can describe what has happened this year—and, Mr. Schulze, to also respond to one of the questions that you asked in your opening statement—is to use two visual aids. The first deals with our receipts of returns this year. It compares the receipts this year to the receipts last year. It is a visual comparison to basically show you what has happened to the gap between the receipts last year and the receipts this year. What it shows you is that over the filing season this year what we have done is to narrow the gap that you mentioned, Mr. Schulze. The last time we were together, I believe it was about the middle of February, and if I recall correctly, we were about 9.7 percent behind last year.

As you can see, over the filing season we have very slowly but surely narrowed that gap consistently week after week. As of April 1, we have 58 million returns filed, which is near dead even with those filed by this time last year.

The reason I think this is significant is that it reverses a 5-year trend toward later filing in the filing season. For each of the last 5 years, gentlemen, we have received returns later. We have consistently had a gap between the current year and the prior year.

This year, we have closed that gap and these receipts, by the way, include some 500,000 electronically filed returns. This is the third year for electronic filing. The first 2 years combined about 100,000 returns were filed electronically. We have gone over the half million mark this year, and I think it is clear to say that electronic filing in the 16 places where it is located this year has been a tremendous success, so much so that many of the return preparers have actually had to curtail their advertising because of the public demand for electronic filing.

The next chart that I would like to show you is also a visual indication comparing this year to last year. It also compares returns that were filed last year with this year's in terms of cumulative numbers over a period of time.

What it basically shows is that this year very closely mirrors last year from the standpoint of receipts of the returns. The receipts figures are important, because everything begins with the receipts of returns. So being dead even with last year in our receipts, it means that we are somewhat ahead of what we actually scheduled for this year.

We also have been able to process the returns and pay the refunds timely this year. Again, as of April 1, we had processed about 47 million of the 58 million returns that we had received, and we are within 1 percent of the returns processed last year at this time.

We have processed and paid 36 million refunds this year, which put us about 2 percent of where we were at this time last year. We have done this because of fewer computer problems this year.

Our National Office Command Center here in Washington, D.C. reports a decrease of between 25 and 30 percent in terms of significant computer problems, that is to say computer problems that would either curtail or stop workflow.

Although there are pockets of under-withholding this year, as of April 1 the average refund remained $20 higher than it was at this time last year. The average refund as of April 1 was $825, compared to $806 at the same time last year.

Overall, based on what we have seen so far, I would say that this has been a very good filing season to date, with a few days left to go in the filing season. By the same token, gentlemen, it has been a challenging filing season, not only to us but also to taxpayers and tax practitioners. It has been difficult, I think, for all of us, because of the number of changes that were made by the 1986 act. That is not a surprise, but I think it is a fact.

For some, preparing their returns has become more complex and more expensive, particularly for the more affluent who have tax-sheltered investments. For others, it has become simpler this year. For example, we have a 5-percent increase in our simplest form, our 1040EZ this year, as compared to last year.

Also, with respect to the longer form 1040, as of April 1 of last year, people filing this form itemized their deductions in about 60 percent of the receipts of the long form 1040. This year, that figure is 48 percent, less than half are actually itemizing their deductions as of April 1 on the long form 1040, and those that are not itemizing, of course, are claiming the standard deduction. For them, no more shoe boxes for receipts. It is simpler for them.

We have seen a modest increase in the returns that are prepared by paid preparers. On April 1 of last year, the returns that we had received showed about 40 percent were prepared by a paid preparer. This year, as of April 1, 42 percent, a 2-percent increase. This increase, however, is in line with what increases we have seen in prior years.

For example, in 1984, after the filing season, we saw an overall 4-percent increase, and for 1982 we saw a 3-percent increase. So my point is that at least at this point in the filing season—and we will have to wait and see when the final figures come in—the growth is in line with what we have seen in prior years.

Now, I would like to turn to pages 6 through 10 of my testimony, if you are following the testimony itself, and talk about taxpayer service.

From the standpoint of our forms distribution, our walk-in assistance programs, where folks can come into the office and get assistance with their returns, our outreach programs, where we actually, through volunteer and other programs, go out in the community to assist the taxpayers, and our teletax program, which is our recorded messages on technical subjects and refunds—all of these functions in the taxpayer service area have all gone very well this year.

From the standpoint of our telephone assistance, our volume is up 10 percent over last year, although it is down from what we had projected for this year. From the standpoint of the timeliness of

our response on the telephone, we estimate that 86 percent of the callers who call us on the toll-free telephones are able to reach us within the first two attempts to call.

Our accuracy rate has been a disappointment to us this year. As you know, the last time I was here I discussed with you our new test call survey system, we call it our integrated test call survey system. This year we are making about 20,000 survey calls to 29 of our call sites to test the accuracy, courtesy and completeness of the advice that we are giving on the telephone.

We have already placed about 15,000 calls this year. At the February hearing, I indicated that our accuracy rate was approximately 75 percent. At that hearing, you will recall that there was a divergence between the IRS testimony and the GAO testimony. After the hearing, in order to attempt to resolve the disparity between the two numbers, we got together and have worked very closely. We went back and both of us reviewed our questions, reviewed the answers, reviewed the techniques that we are using on the telephone and we both made changes in what we were doing.

As a result of those changes, the GAO accuracy rate increased slightly and the Internal Revenue Service rate went down some. After the changes were made, as of the February date when I testified before, our level of accuracy with the revisions was about 71 percent, instead of 75 percent, and it has increased to slightly over 72 percent for this filing season.

I would like to give you an assessment of that. From the standpoint of the courtesy, the willingness of our tax assisters to put in additional hours on training, from the standpoint of their willingness to be available for extended hours to taxpayers, I think our telephone assistance this year has been excellent. But from the standpoint of our accuracy, I will tell you gentlemen that we are not satisfied. We must and will improve our accuracy for our customers.

I would like to stress that the problem here is not with our people on the telephones. In terms of their willingness to do what was asked, they have responded and responded well. This is a management responsibility to improve the system that we are using and the taxpayer service function, and it is a challenge that I and the other management and executive representatives of the Internal Revenue Service accept. Now, how are we going to do it?

One of the things that we have had to do this year is go back to some very basic analysis with respect to our telephone assistance survey system. Based on some questions that I was asked the last time I was here, we have taken a hard look at our turnover in the taxpayer assistance area, I think it is time this area needs to be addressed.

First, we are going to convert our seasonal and temporary employees to permanent employees as we are able to do so, and increasingly.

Second, we are going to create additional grade levels so that we have a career pattern that we can offer in taxpayer assistance. We think by doing both of these things we will be able to recruit and also retain more experienced folks longer to put on the telephones.

Third, from the standpoint of the training that we give, we are going to continue with the early hiring. We are also going to im-

prove the materials and techniques that we are using in our training. One of the things that our integrated test call survey system taught us this year is that there are areas and there are ways where we need to improve. We think we can improve with the training materials and techniques that we are going to be using.

From the standpoint of the on-the-job training, we plan to do as much or more as we did this year, but to continue the on-the-job training before the assisters are actually introduced to the public from the standpoint of being occasionally supervised and not continuously supervised.

Another thing we are going to do is this: In the budget for next year—and I will be discussing this a little bit later—we do have an automated project for taxpayer service. It actually will automate each of the work areas for each of our tax assisters. We are going to begin the prototype in Dallas in the coming fiscal year. We anticipate spreading it nationwide into 1990 and we expect to be operative with it in 1991. This is going to bring technical materials, forms, publications, and that type of thing to our assisters. It will also provide them with additional information about taxpayer accounts and it will connect them with various parts of our organization directly, problem resolution and our forms distribution sites.

We also will have further suggestions—I will cover them in a second. But I have tried to address first and foremost that we need to improve the taxpayer service function itself from a management, supervisory standpoint.

I think it is also fair to say that our integrated test call survey system taught us something else this year. It taught us that as we were using this type of system to measure overall accuracy, we have many benefits from it. It gives us the tools to actually measure accuracy and to report that accuracy, not only to our own employees but also to the public as well. And it permits us to provide instant feedback to our call sites about areas where we could improve, where we are having problems.

But something else that we have learned with our integrated test call survey system is that we are going to have to make changes in it in order to permit the survey system itself to more closely reflect the actual accuracy that is taking place out there on the telephones.

One of the things we plan to do in this regard is to expand the number of subjects and categories of tax questions that we are actually going to use beyond what we had this year. We are also going to better pattern the folks that are on the telephone making the survey calls, better pattern their behavior to actual taxpayer behavior, because in monitoring the live calls we have found that they were somewhat different.

We do have some suggestions for the coming year to make in order to reduce the disparity between the Internal Revenue Service and GAO figures on our accuracy rate for next year. This morning, I would like to propose to GAO and also to you on the subcommittee that we ask IRS and GAO jointly to develop a telephone monitoring project for the coming year. We would work together and then come back and report to you on the subcommittee what we have come up with in the way of an overall approach and an overall monitoring activity, so we will not continue to have the dispari-

ty between our two numbers. I think we are to that point and I hope you and GAO will agree.

The final point I would make is that I would like to ask you for assistance in this area. There are two things that you could do for us. One, help assure stable funding for our taxpayer service programs. We will, as I mentioned, have further recommendations later this year, after we get through with an analysis of the additional things that we might do in our taxpayer service system, and we will be back with you and hope you will continue, as you have in the past, to give us your support to get the stable funding that we need in order to improve our taxpayer service system.

Second, we would like to ask you to join with us in minimizing changes in our tax law. We think it is important that taxpayers, tax practitioners and tax administrators be given the opportunity to get used to this new law.

I would now like to turn to our 1989 budget. I will go through it quickly with you and then I have some visual aids that I would like to discuss with you.

Our request for 1989 is for $5.3 billion and about 114,000 average positions. This represents an increase from our 1988 budget of some $241 million and 1,650 average positions.

With this funding, we intend to continue balancing the two important overall functions of tax administration, our compliance functions and our service functions. As indicated on page 12, this budget will permit us to place the service centers on a sound basis to handle the increased workload in tax returns during fiscal 1989. As indicated on page 13, it will also permit us to improve our service center correspondence by providing explanation to taxpayers with respect to interest computations and penalties.

It also will permit us, as indicated on page 14, to continue our current level of taxpayer service support. As indicated on pages 17 through 19, in addition to what we will be able to do on the service side of tax administration, it will also permit us to enhance compliance in the law enforcement area by further increasing tne staffing in our criminal investigation function and balancing our general enforcement programs and our special enforcement programs. The special enforcement programs deal with organized crime and drug abuse. Our general enforcement programs are our general tax fraud investigation programs.

We will do this through an increase in staffing and also by providing better equipment to our criminal investigators. With this additional budgetary authority, we also will be able to increase staffing in our international area, to provide better service to American taxpayers abroad and also increase our compliance overseas.

As indicated on pages 15 through 19 of the testimony, one of the major areas that this budget will assist us on is to support improvements in our technology, to enable the Internal Revenue Service personnel to increase their efficiency and effectiveness in the compliance and the service areas, again balancing it out.

With the additional funding that we are requesting for 1989, we will be able to enhance our integrated collection system and actually automate collection overall, carrying our automated collection system one step further. We also will be able to continue with our plans to automate our examination capability, and with the fund-

ing that we are requesting this year, we will be able to automate our criminal investigation capability. That is on the compliance side of the organization.

On the service side of the organization, we are requesting funds in order, as I mentioned, to pilot our automated taxpayer service stations for our telephone assisters. It also will permit us to continue to expand our electronic filing program which, as I mentioned, has been so successful this year.

And finally, and perhaps more importantly, the funding that we are requesting for fiscal year 1989 will permit us to begin in a major way to actually undertake a redesign of our tax system and to replace the 1950's technology with state-of-the-art technology, in order to be able to do the things that we are not presently able to do, to more timely process returns and pay refunds, to give taxpayers more timely information with respect to their accounts in collection, and in examination to more quickly retrieve tax return information and do the computations and the research work that we need to do there.

This is something that I see as the major challenge and opportunity that I think tax administration has in the next 5 to 10 years—that is to redesign our tax system and permit us to give the kind of service, whether it is on the compliance side or the service side of the organization that we ought to be giving to the American public.

I would like to summarize this testimony very quickly with a series of charts, because I thought they might be helpful to make the visual points that I have been discussing.

The first chart is an interesting chart. I call it to your attention because it shows the shift in the balance of our funding between our compliance or enforcement activities and our service activities.

What this chart is intended to show you is that since 1984 we have been better able, with your help, to balance the activities of the Internal Revenue Service between the compliance and enforcement side of the organization and the service side of the organization.

The pie chart on the left represents funding for fiscal 1984, the year before we had the problem in our service centers. It shows that 70 percent of our resources were devoted to compliance and enforcement, and 30 percent of our resources were devoted to serving taxpayers.

What we are talking about for fiscal 1989 is to make a substantial change—to devote 60 percent to the compliance function, but to increase the service function to 40 percent. It is what I talked to you about before, balancing compliance with service.

Your help has been substantial and has been significant in the past in being able to do this. I hope you will continue to do so.

What I would now like to do is to move in and visually make the points——

Mr. THOMAS. Have you changed the definition of enforcement and service between the two?

Mr. GIBBS. Mr. Thomas, we have not. We have not and we will be glad to provide you with detailed backup——

Mr. THOMAS. Yes, I would like the definitions.

Mr. GIBBS. I would be happy to. I will be happy to provide that for you.

What I would like to do with the next series of charts is basically show you how we intend in fiscal 1989 to use the funding we are requesting between the enforcement or the compliance side of the organization and the service side of the organization.

The first two charts basically make the point to you that in fiscal 1989, the Internal Revenue Service will devote $70 million and 1,489 average positions to the narcotics program and drug investigations. What we are trying to show here is that we are a major partner in the Organized Crime and Drug Enforcement Task Forces. We participate in 7 out of 10 of the Organized Crime and Drug Enforcement Task Forces cases that are conducted by the Federal Government. That puts us second only to the Drug Enforcement Administration in terms of the amount of resources we devote to those types of investigations.

Another way of taking a look at what we have done in the criminal investigation and drug enforcement area is to compare fiscal 1987 and fiscal 1980, fiscal 1987 being the last year we have actual data for and fiscal 1980 being the start of this Administration.

During that period of time, we have significantly enhanced the participation of our criminal investigators in the drug enforcement program, and here are the results. With respect to indictments, the indictments that we obtained in fiscal 1987 are about 2,300 percent over fiscal 1980. Convictions in 1987, 1,600 percent over what we did in 1980. The percent of those convicted and sent to prison increased about 115 percent. Total fines paid has increased to $11.8 million in 1987 some 2,400 percent over 1980.

In short, with the funding that we are asking for on the enforcement and compliance side of the organization, we think we do have a track record, we think we do have customers out there in terms of other Government agencies in the drug enforcement area, criminal area, organized crime area that are pleased with the quality of the service they are receiving from the Internal Revenue Service. That is the basis for basically saying that we can put the funding we are asking for in the law enforcement area to good use.

Now, let me move to the service side of our organization and tell you what we plan to do with the funding that we are requesting for fiscal 1989. With the additional funding in taxpayer service, we intend to answer 37.4 million telephone calls, service 7.2 million office visits from taxpayers, respond to some 200,000 pieces of correspondence, and provide information on selected tax topics with recorded messages to about 12 million taxpayers.

Almost 1 million taxpayers will attend seminars and receive group tax return preparation through the Community Outreach Tax Assistance Program. Our VITA and tax counseling programs should reach an additional 2.5 million taxpayers. Our understanding taxes program, which explains tax administration to high school and college students will reach about 3.7 million taxpayers.

None of this includes the 18.5 million orders that we expect to receive in our three forms and publications distribution sites next year, it also does not include the forms and publications that we will have available in our office sites and at post offices, banks and libraries, and finally it does not include the tax packages that we will make available to taxpayers.

Mr. THOMAS. This is prospective 1989. I would like to see comparable 1987.

Mr. GIBBS. I would be happy to provide that for you.

The next chart basically is the key chart from the standpoint of our workload efforts. Our whole operation really begins with returns filed, because the returns filed basically determine how many returns we will process, how many returns are to be examined, the collection of our unpaid accounts, the investigation in the criminal area, and all of these revolve around the number of returns.

Basically, what this continues to show you is that with 183 million returns in 1987, we increase to about 187 million this fiscal year, and we are anticipating about 191 million returns next year.

The final chart that I have to show you simply summarizes what we feel our program responsibilities are and what we will be doing overall with the funding that we will be receiving and that we are requesting in 1989.

With the $5.3 billion that we are requesting, we will process about 191 million returns, process and match close to 1.1 billion information returns, issue about 80 million refunds, assist 64 million taxpayers, examine 1.5 million returns, collection 3.3 million delinquent accounts, and secure 3.5 million delinquent returns.

For the first time, as I indicated I think in one of my prior hearings, in fiscal 1989 we expect our gross revenue collections with our tax system to exceed $1 trillion. Out of that, we expect to pay $90 billion to 80 million taxpayers. That leaves a net revenue to the Federal Government of $901 billion.

Again, your support in the past has been considerable, it has been effective, and it has been appreciated. We will continue to try to balance the compliance and service efforts. We will continue to enhance and attempt to improve things like our telephone accuracy rate with the funding that we are asking for and that we look forward to and ask you for your continued assistance.

Thank you.

[The prepared statement of Mr. Gibbs follows:]

STATEMENT OF

LAWRENCE B. GIBBS

COMMISSIONER OF INTERNAL REVENUE

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss several topics of importance. With me today are Senior Deputy Commissioner Michael Murphy and Deputy Commissioners Charles Brennan for Operations and John Wedick for Planning and Resources. I have also brought with me several of our Assistant Commissioners and our Taxpayer Ombudsman. After my oral statement, we would be happy to answer any questions you have.

## I. INTRODUCTION

My written testimony today is divided into two parts. First, I will cover the status of the 1988 filing season to date. Second, I will present the broad outlines of our fiscal year 1989 budget request.

## II. THE 1988 FILING SEASON

All in all, the filing season has proceeded very smoothly. It is not without its difficulties, but given the vast changes to the tax law made by the Tax Reform Act, this filing season is very much in line with the past two successful filing seasons.

### 1. Returns and Refunds

We continue to be encouraged by the rate of returns being filed and processed. Despite the magnitude of changes in the Tax Reform Act, the challenge of communicating these changes to all taxpayers and the substantial task of changing our published technical guidance and internal computer systems, we have not experienced any major problems as we reach the end of the filing season.

When I testified in February, our receipts of tax returns in our se vice centers were approximately 6% behind last year. As expected, the pace of filing has picked up since then. For the week ending April 1, 1988, the IRS had received over 58 million individual income tax returns. This is almost exactly the same number IRS had received at this time in 1987. Thus, although a significant number of returns will be filed in the last weeks of the filing season, we do not anticipate any major shift in the late filing trend in comparison to last year.

Our processing of the returns that we are receiving also is going smoothly. For the week ending April 1, 1988, IRS had processed over 47 million of the returns it had received. This is within one percent of the number of returns we had processed at this time last year (47.4 million).

The average refund is still above what is was last year. For the week ending April 1, 1988, the average refund was $825. At this time last year, it was $806. We have issued 36.1 million refunds to date compared with 37.0 million refunds at this time last year, down only 2.3%. Although the number of refunds is down slightly at this point, it does not appear that there was significant underwithholding for large numbers of taxpayers. However, as I testified at the Februar hearing, there are pockets of underwithholding among certain groups of taxpayers such as two wage earner couples and higher income taxpayers, particularly those who previously had made tax sheltered investments.

### 2. Filing Trends

One comment we have heard is that the number of returns prepared by professional preparers would increase significantly. Our data to date shows that the number of such returns is, in fact, higher this year: 42% of all returns filed thus far have been prepared by professional preparers compared to about 40% at this time last year. However, this increase is

not out of line with the growth in professionally prepared returns during the 1980's. For example, the number of professionally prepared returns increased from 41% for Tax Year 1983 to almost 45% for Tax Year 1984 returns and from about 37% in Tax Year 1981 to 40% in 1982. One explanation for this growth in the number of professionally prepared returns could be the explosion of tax legislation in the 1980's. Whatever the reason or reasons may be, the fact remains that based on the data we have to date, the increase we are seeing this year, is in line with we have seen this decade.

It was projected that Tax Reform would reduce the number of taxpayers who would itemize their deductions on their returns. Our tatistics thus far bear that claim out. Last year at this time 60% of all taxpayers who filed a Form 1040 itemized their deductions. This year about 48% have itemized deductions. In the long run, this means that a substantial portion of taxpayers will be able to switch to shorter and easier tax forms such as the 1040A and 1040EZ.

These trends, combined with the numbers we have on returns filed and processed, tell us that Tax Reform, while no doubt challenging to some, is largely having the effects on the system which were predicted and is not resulting in critical problems from a tax administration standpoint.

3. Forms Distribution

One of the problems that was brought to our attention at this Subcommittee's earlier hearing dealt with the supply of forms and publications at a few of our district offices. As a result, we have revamped our policies for stocking forms. Field offices now regularly monitor the stock levels of available forms. We have also expanded the distribution of some of the more in demand forms--Form 4868, Application for Automatic Extension, for example--to anks, post offices, and libraries in addition to IRS offices. We are taking these actions in anticipation of an increased demand for such forms in the last weeks of the filing season.

4. Computer Processing

Our computers are running smoothly. In fact, 30% fewer significant problems have been reported in comparison to last year to our National Office Command Center which monitors our computer operations on a daily basis.

5. Electronic Filing

As of April 4, 1988, over 500,000 returns had been filed electronically with the IRS. There are more than 2,400 preparers and 61 software firms participating in this year's program. The two service centers that are receiving and processing electronic returns--Ogden and Cincinnati--report no major problems with the program.

6. Taxpayer Service

Thus far, we have answered a total of 15.7 million phone calls on our toll free lines. This is running elow our projected volume of 17.1 million calls at this time, but is 1.7 million calls above last year. At our current level of service, over 86% of taxpayers calling the IRS are able to reach an assistor on their first or second call attempt.

The accuracy rate of our answers to technical tax questions continues to concern us. As I explained in our testimony before this Subcommittee in February, IRS is using a new test call system that helps us measure the technical

accuracy of our front line assistors and identify more specifically areas which need improvement. The Integrated Test Call Survey System permits us to call our assistors across the nation and ask them test questions. We expect to make approximately 20,000 such calls this filing season and have made approximately 15,000 thus far.

In February, I testified that our new test call system was indicating an accuracy rate of 74.8%. That figure, however, was significantly different than the preliminary test call accuracy rate which GAO had found using their system. As a result, we reviewed our test call questions and answers with GAO in March to try to ensure that both IRS and GAO were satisfied with the technical and statistical validity of our respective test call systems. GAO made several recommendations to us at that time which we have implemented in our test call questions and answers. We also rescored all of our data for this year so that our figures would reflect these changes consistently through the filing season. Pursuant to this rescoring, our test call system shows that the accuracy rate at the time I testified in February was 70.7%. For the week ending April 1, 1988, the rate had risen to 72.1%.

It is important at this point to provide some additional detail on what we and GAO are measuring in our test call systems. Both systems accurately measure the accuracy and completeness of answers given to certain questions asked by our respective monitoring staffs. In the case of both the GAO and IRS test call systems, the test questions are intended to sample categories of questions taxpayers are asking.

Let me summarize the conclusions we have drawn about our test call system. First, we feel very strongly that the development of our own test call system this year was a very important step in providing IRS management with the statistically valid information it needs to identify specific problem areas n the quality of our responses and to provide timely feedback to our telephone assistors. We are committed to continuing this system in the future as part of our effort to improve the quality of our systems. We believe, however, that improvements can be made to the test call methodology. For example, we plan to increase the number of questions and categories of tax law that the test call system measures.

We also believe that improvements to both test call systems may be made to better reflect the accuracy of answers to "live taxpayer calls". Our monitoring of live calls indicates that the accuracy of answers to live calls from taxpayers is somewhat higher. One explanation for this variance seems to be that if our initial answers to taxpayers for any reason do not fully and satisfactorily address their questions, the taxpayers generally continue to supply information or ask additional questions until they are satisfied that their questions have been completely addressed. This contrasts with the test call systems of IRS and GAO which require significant probing by our assistors to draw information from the test callers. We will continue to work on our system with GAO and independent experts to try and incorporate this dynamic of the way taxpayers interact with our assistors.

Second, we are not satisfied with the accuracy rate as it is now. Accurate service to taxpayers will c ntinue to be a long term IRS priority. We will continue to identify steps which we can take to improve the quality of our telephone assistance. Let me point out a number of initiatives that are underway to upgrade the quality of taxpayer assistance. Later this year we will begin a prototype of our Automated Taxpayer Service project. The Automated Taxpayer Service Project will

provide front line Taxpayer Service assistors with an automated technical reference data base. This will allow us to insure that all assistors have quick access to the same information to answer technical calls. In addition, the system will provide on-line account information to each front line assistor. The prototype of this system is due to be installed in our Dallas Office in July of this year. If the prototype is successful in the 1989 filing season, we intend to take it nationwide in FY 1990 and have it completely installed by FY 1991.

We also have begun to convert more Taxpayer Service staff from seasonal to fulltime status, and we plan to increase the number of our more technically proficient Taxpayer Service Specialist positions. We believe these actions have the potential to make the jobs in Taxpayer Service more attractive and to improve our ability to retain our more experienced people. Based upon the data we will receive from this year's filing season and additional analyses that we are presentl making in this area, we will be in a position to make more specific recommendations in this area later this year.

We are already beginning to plan for next year based on a thorough evaluation of the strengths and limitations of our program this year. We believe that the commitment we have made to quality in our Taxpayer Service function will carry through to significant improvements in the years to come. I would suggest, Mr. Chairman, that we need your assistance in two areas: 1) Assuring a stable level of funding for Taxpayer Service, and 2) Minimizing further tax law changes.

7. Summary

Mr. Chairman, although I am not satisfied with where we are in the toll free accuracy area, I do not think that the accuracy rate for toll free service should override the accomplishments of this filing season, including what we are doing in our Taxpayer Service area overall. The IRS has been given a formidable task with the implementation of the Tax Reform Act of 1986 and most of the indicators thus far tell us that we are doing a very good job this filing season. I am proud of the planning and hard work of all of our employees to make this a successful filing season in a year when we faced the most significant tax law changes in our Natio 's history. It is no secret to you and others, Mr. Chairman, that this is our third consecutive successful filing season. If this filing season continues to go as well as it has for the last three months, I personally will be pleased with our overall performance, particularly in light of the added challenges of Tax Reform.

## III. FY 1989 BUDGET REQUEST

For Fiscal Year 1989, we are proposing a budget that we estimate will collect almost $910 billion in tax revenue, net after refunds. We expect to process 191 million primary tax returns, issue 80 million refunds, provide information and educational material to taxpayers, and assist over 64 million taxpayers through all forms of assistance, including toll-free telephone service and taxpayer education. We will continue modernization of our computerized information systems to ensure a tax system that is both effective and fairly administered as well as responsive to taxpayers. Finally, we will continue our participation in efforts to combat organized crime and drug abuse.

Our proposed budget to carry out these activities totals $5.3 billion and 113,811 average positions, an increase of about $241 million and 1,650 average positions over the revised FY 1988 level. This budget request co tinues to emphasize the importance of quality service to the public.

1. Ensuring Sound Tax Processing

A continued priority in 1989 is to make certain that our service centers are on sound footing. We plan to maintain in 1989 the same key objectives we are achieving in 1988, that of providing quality customer service, as well as maintaining a responsible compliance presence, both of which serve to uphold our voluntary compliance system.

We are requesting additional funds to maintain tax processing operations in the face of a growing workload. We estimate that 191 million tax returns and 12 million supplemental documents will be received and processed in FY 1989, almost 4 million more tax returns and 700,000 more supplemental documents than in FY 1988.

One item contained in our budget request that is particularly important, Mr. Chairman, is funding to improve service center correspondence with taxpayers. GAO has noted our need to improve the accuracy of our responses in this area and we agree with this observation. We anticipate mailing over 3 million additional n tices containing interest and penalty computations and explanations to taxpayers on all taxpayer accounts where money is owed by the taxpayer and on refunds that include interest.

We also plan to increase the size of the problem resolution program staff in our ten service centers and 63 district offices. This program acts to solve taxpayer problems that have proved difficult to resolve quickly. The additional staffing will focus on greater identification of system problems and their causes, to ensure protection of taxpayer rights and efficient tax administration.

2. Maintaining a High Level of Taxpayer Service

As I mentioned earlier, our FY 1989 program continues our efforts to upgrade the quality of our taxpayer services. Some 64 million taxpayers will receive direct assistance and taxpayer education in FY 1989.

We will continue to provide service to the public through our toll-free telephone, walk-in and correspondence programs. Our Community Outreach Tax Assistance Program will again provide tax law information and group t x return preparation assistance at community locations. For example, we have requested $2.7 million for our Tax Counselling for the Elderly Program, which provides tax assistance for those over 60. Our taxpayer information media campaign will continue with the aid of the Ad Council. Increased emphasis will also be placed on assisting taxpayers after the filing season with notice or account-related problems.

As I indicated previously, we expect to have additional actions and activities underway in FY 1989 and beyond that we believe will substantially improve our Taxpayer Service function.

3. Information Systems Initiatives

IRS handles a massive work volume each year -- processing hundreds of millions of transactions, collecting hundreds of billions of dollars and touching the lives of a significant portion of the population. Accurate and timely information is essential in carrying out our mission to administer the tax law promptly, accurately, efficiently, effectively, and fairly.

In February, I told this Subcommittee that we can't provide the quality f service we feel we ought to be providing to the public because we can't quickly access the information we have in our antiquated tax processing system. This delay in getting the information we need to do our job needlessly frustrates our customers.

An important objective in FY 1989 is to continue the modernization of our tax administration and other systems to ensure they can support a tax system which is responsive to taxpayers. The FY 1989 request for additional ADP and systems modernization of $137 million is aimed at continuing many ongoing ADP projects, including the redesign on the tax administration system. This is a timely request when we consider that we project a gross collections (before refunds) of one trillion dollars in FY 1989.

We must replace the antiquated tax administration system that is beginning to groan under the weight of demands it was not designed to meet. The taxpaying public is accustomed to dealing with private sector organizations which have the capability to retrieve information quickly and accurately. IRS must be able to provide service to our customers that is at least equal to that available in the private sector. Our Tax System Redesign project is aimed at achieving this typ of service.

A request for funding is also included for other projects such as the Integrated Collection System which builds on the success of the Automated Collection System to bring all collection automation efforts into one integrated system. This system will improve service to the taxpaying public and assist us in managing our ever increasing workload. Other ADP projects such as Electronic Filing and the Automated Taxpayer Service System will improve direct services to taxpayers.

The Electronic Filing Program, now in its third year, is perhaps our best hope for substantially reducing the cost and burden of collecting tax information. Over the last three years this program has grown so that it now accepts both individual and business returns and has been expanded from three metropolitan areas to 16 IRS districts, 10 of which comprise complete states. By 1991, we expect electronic filing to be available nationwide. This year for the first time IRS is offering taxpayers in all electronic filing locations the option of having their refund deposited directly into their bank account by electronic funds transfer.

We believe the growing volume of individual electronically filed returns shows the public interest in the program. During the last two years combined, 1986 and 1987, only about 100,000 electronic returns were filed. Already this year, over 500,000 eturns have been filed electronically. Next year, the program has the potential to reach a significant portion of the taxpaying population.

As we enter the 1990's and confront increasing workload demands, IRS cannot hope to meet the needs of taxpayers, without modernizing its information systems. To maintain this effort, it is crucial that full support be given to our ADP systems modernization request.

4. Law Enforcement

One item in our request that I particularly want to emphasize is the addition of greatly needed resources in Criminal Investigation to maintain a balanced enforcement effort.

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Increased staffing will be devoted to our general enforcement program, as well as our drug enforcement and money laundering activities. This will permit IRS to continue its efforts in the more traditional criminal tax investigation activities as well as the thirteen Organized Crime Drug Enforcement Task Forces and Operation Alliance, a multi-agency drug initiative along the Southwest border. IRS continues to be first among all the Treasury bureaus and second in all of go ernment in the level of commitment of resources to anti-drug task force operations related to financial investigations. Our request includes funds to upgrade our obsolete, non-secure two way radio system to make it compatible with other law enforcement radio systems and provide greater security for our agents.

5. International Tax Administration

With more U.S. taxpayers living abroad, more American corporations conducting business in foreign markets, and greater numbers of nonresidents having U.S. sources of income, IRS must ensure that taxpayer assistance and compliance presence is felt both at home and abroad. Our FY 1989 International program increases taxpayer service and education abroad by enhancing our public affairs program in the international media to explain and provide more information about U.S. tax requirements, expanding the number and length of overseas assignments by taxpayer assistors, and initiating a toll-free telephone assistance program for taxpayers in Canada and selected European countries.

Increasingly we are asked by foreign governments to provide assistance in treaty development, joint tax administration endeavors, and exchanges of information on foreign tax cases. Joint resolution of tax jurisdiction is particularly important in cases of double taxation, to determine the proper amount of taxes owed o the United States Government. Our request contains a $1.1 million program increase to meet the growth in workload in this area.

## IV. CLOSING

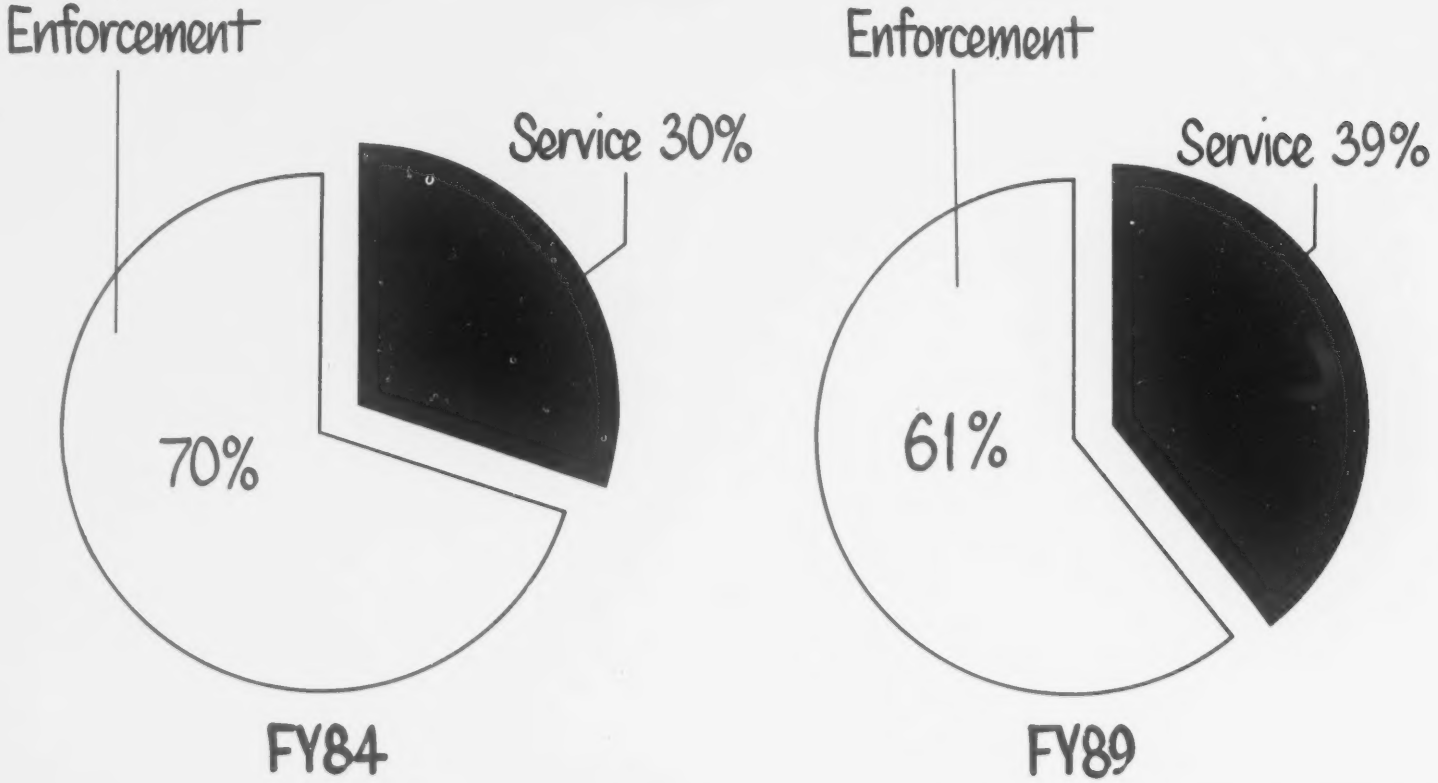
In my remarks today, I have stressed IRS' role of service to the American public. At the same time it is important to remember that the Service is one of the principal agencies of our federal government capable of addressing the budget deficit through both our compliance and service programs. IRS continues to be an effective revenue center for government, generating the revenues upon which the other functions of government depend, at a cost of about 49 cents for every $100 collected.

Our budgets in 1988 and 1989 provide a balance between service to the public and ensuring compliance with our nation's tax laws. I remain convinced that this balanced approach is essential in the long run to sound tax administration.

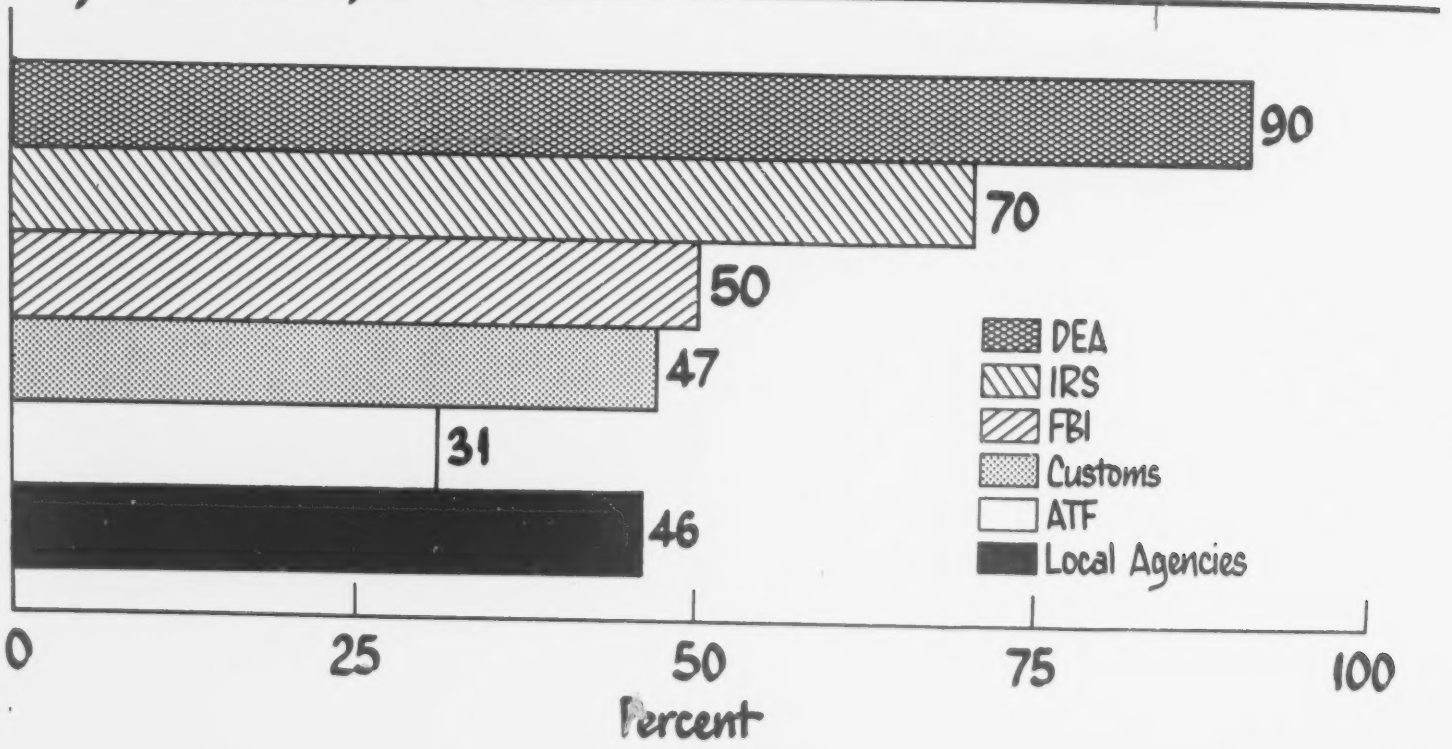
What makes our tax system unique is our history of voluntary compliance. How we maintain that tax system will determine the degree to which that compliance will continue. In the long run there is only one way to maintain confidence and re pect in the system -- by providing high quality service to taxpayers. Our proposed budget, we believe, helps support this goal.

Mr. Chairman, this concludes my prepared remarks. We will be pleased to answer questions you or the members of the subcommittee may have.

# Service and Enforcement Resources



# Percent of Agency Participation in Drug Investigations Begun During CY 1986



# Criminal Investigation
## Drug Enforcement

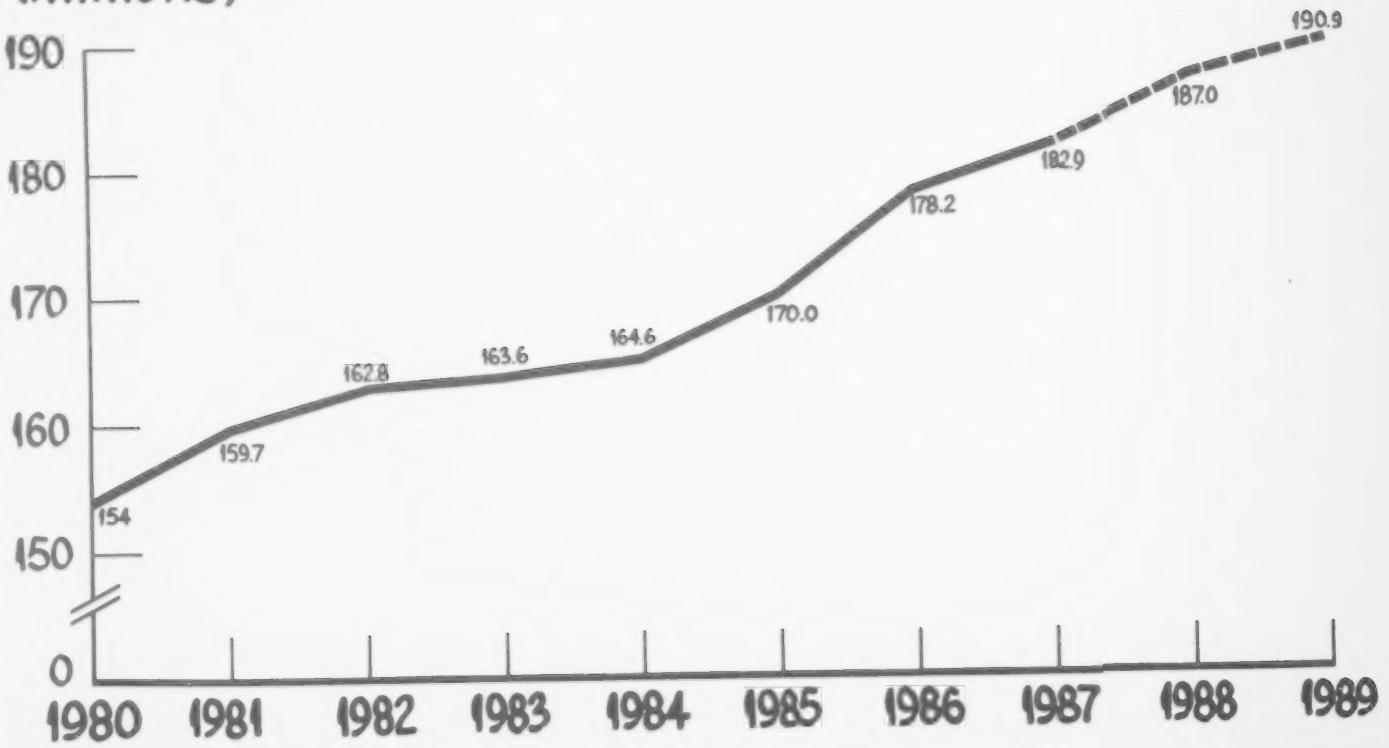
| | FY 1980 | FY 1987 | % FY87 Over FY80 |
|---|---|---|---|
| Indictments | 39 | 898 | 2302% |
| Convictions | 42 | 680 | 1619% |
| Percent of Convicted Sentenced to Prison | 67% | 77% | 115% |
| Total Fines (Thousand of Dollars) | $489 | $11,787 | 2410% |

# Taxpayer Service

| | Millions |
|---|---|
| Telephone Answering | 37.4 |
| Office Visits | 7.2 |
| Correspondence | 0.2 |
| Recorded Messages | 12.0 |
| Outreach | 1.0 |
| VITA/Tax Counseling | 2.5 |
| Taxpayer Education | 3.7 |
| TOTAL | 64.0 |

# Returns Filed

(Millions)



# Internal Revenue Service
## Program Responsibilities

| | FY 1989 |
|---|---|
| Tax Returns Processed | 191 Million |
| Information Returns Processed | 1.1 Billion |
| Refunds Issued | 80 Million |
| Taxpayers Assisted | 64 Million |
| Returns Examined | 1.6 Million |
| Delinquent Accounts Collected | 3.3 Million |
| Delinquent Returns Secured | 4.0 Million |
| Gross Revenue Collections | $1.0 Trillion |
| Refunds | $ 90 Billion |
| Net Tax Revenues | $910 Billion |

Chairman PICKLE. Thank you, Commissioner. You have given us a good report, a good overview estimate of present conditions and your hopes for the next filing season. I am happy that the tax season this year is on schedule and no more than 1 percent off in returns, refunds and processing. It seems that things are normal, in spite of the big tax change and the new computer system, that we are still keeping up in good form. Overall I think that is encouraging to us.

Now, let me ask a question on the aspect of this overall report which seems to be getting more press than anything else. Incidentally, I am going to ask the members to try to stay within the 5-minute limit and we will come back for additional questions if anybody wants to.

You report now that while earlier you thought telephone assistance had a 75-percent accuracy rate, now you have rerun it. Now you say it is 72 percent, instead of the 71 percent which at one point was what you had established, an improvement of some 1 percent. The GAO will report that your accuracy rate is only about 62 percent, so let us just speak in general terms.

You have 72 percent accuracy and GAO has 62 percent. I told an inquirer yesterday from the press that those figures are not acceptable, that you get better odds at Las Vegas, and I did not mean that in a flippant sense, but I am trying to say the public is distressed.

Now, you indicate that you are going to do something about that and apparently you are going to do it by increased training, by making more assistors permanent staff, through increased counseling for the elderly and with other approaches.

How do you think the public feels now when the press or the radio and television says that when you call IRS you are going to get the wrong answer in one out of four times or worse?

Mr. GIBBS. I think the public basically identifies with the difficulty that they and we and their practitioners had this year in terms of the learning curve of going up with dealing with the new law. I do not think there is any doubt about that.

Chairman PICKLE. Say that again.

Mr. GIBBS. I think the public basically can identify with that in terms or the number of changes that we have seen this year. I think they and we are learning about this new law and we recognize, Mr. Chairman, that there is a learning curve. We are not satisfied with this.

Chairman PICKLE. Well, I think that in social gatherings, in business circles, in barroom talks, I think there is sort of a jocular teasing, "My God, you only get the right answer one in four times," that is not acceptable and it certainly cannot be to you.

Now, my question to you is you do not show in your budget—you are asking for additional help in taxpayer services, but you do not show, as I get it, any real increase in taxpayer services.

Mr. GIBBS. One of the things——

Chairman PICKLE. Is that correct?

Mr. GIBBS. One of the things that I would like to point out is that the funding is approximately level, but by the same token we do anticipate that in terms of the demands of this filing season, this

filing season is likely to be much more demanding than will be the one next year.

Chairman PICKLE. All right.

Mr. GIBBS. The other thing, Mr. Chairman, that I would point out, we have requested from the administration and received the additional 4 percent flexibility to transfer funds into taxpayer service if we needed it. We had it this year and they continue to grant it next year.

We will come back, as I mentioned, with recommendations and tell you what the costs will be in terms of some of the changes we plan on making.

Chairman PICKLE. In your budget submission you indicated that you would respond to 44 million telephone inquiries, but now you are showing me that you are going to respond to 37 million. What is the correct estimate?

Mr. GIBBS. I am told that the difference is that we have three distribution sites for forms and publications, and they receive telephone calls separately from the folks that are on the telephone answering the technical inquiries and the account questions, and that is the reason for the difference.

Chairman PICKLE. It looks to me like you are saying that you are going to—in your budget, you are going to answer 44 million, and now you show that you are going to answer really only 37 million, and maybe as a breakdown within your system, but on the surface it looks like you are really going to be answering nearly 7 million less calls.

Mr. GIBBS. As I indicated as I was describing the chart, that chart did not include the telephone calls that come into the——

Chairman PICKLE. Why did you not request additional personnel for telephone service accuracy, to improve your accuracy picture?

Mr. GIBBS. Mr. Chairman, again, at the time that we requested that budget last fall from the administration, we had not gone through the filing season from the standpoint of knowing what our accuracy would be.

Chairman PICKLE. All right. Now, you requested from Treasury originally 127,000 positions, totaling about $6.2 billion, and yet the OMB budget you approved shows about 13,000 less positions. Why did you think you needed 13,000 positions and now accept and testify that all you need is the reduced number of about 113,000 people?

Mr. GIBBS. Mr. Chairman, Treasury reduced our original request by 2,633 average positions and $352 million. OMB reduced our request by another 10,659 average positions and $519 million. Overall, the Administration met 90 percent of staffing requested and 86 percent of the funds requested by IRS for 1989. The fiscal year 1989 budget requested was in keeping with the budget summit agreement reached in December between Congress and the Administration.

Chairman PICKLE. Your new figures then show that—are based on the budget summit and you felt that you needed these 127,000 positions and you have only got 113,000. Now, that means that you would want these extra funds, because you have estimated that you need them. Now, how would the Internal Revenue Service allocate additional staffing over the 1989 level, if you had them?

Let us say you had 1,500 additional staff, what would you do, where would you use them?

Mr. GIBBS. With my testimony this morning from the standpoint of telephone accuracy and the other question you just asked me, one of the things that we would do with the additional funding is to take a hard look, as I mentioned, at how we would balance the additional funding between the service side and the compliance side of the organization. On the service side I will be happy to give you additional recommendations, as I indicated, when we develop some recommendations for how we would spend the additional funding on that side of the budget. On the compliance side, on the enforcement side, we basically would spend the money as we had indicated in the revenue initiative that we had proposed to the administration back in the fall.

If you would like, I would be happy to go through the various categories with you, but it basically would be spent in the examination initiative, examining more returns, and also collecting more of the accounts receivables. I would be glad to provide this for the record in terms of the breakdown, if that would be helpful.

Chairman PICKLE. I would like to have that breakdown. If you had the extra positions, would you increase the personnel in your telephone taxpayer assistance services? You did not request that money and you said you did not because you did not anticipate the budget summit. Now, that was made last fall and this is April, what would you do for next year?

Mr. GIBBS. All right. With respect to——

Chairman PICKLE. Or if we get the additional appropriation this fall, where would you put it?

Mr. GIBBS. With respect to the telephone assistance, to some extent that is going to be determined by what we think will be the demand for our services next year, and that is something that we are going to have to sort out after the filing season this year, because, as I indicated, although we had more calls this year, we did not have as many returns as we were expecting. I will be happy to get back with you with recommendations on that.

Chairman PICKLE. I want to go further into a lot of questions, particularly in the examination and other areas, but my 5 minutes are up. I want to conclude by saying to you that I think it is impressive that you have handled as many as you have, with the emphasis that you are putting on taxpayer service for the first time.

I am not always sure that the individual calling you gives all the facts that he or she should give to the telephone IRS people to begin with, and I would think estimating accuracy is a questionable thing just on the surface of it. Nevertheless, you cannot let the public continue to think that your rate of accuracy is less than 75 percent. That is not acceptable. We cannot accept that and you have got to improve it, and if that means more staffing, more permanent positions, we have got to do that.

Mr. GIBBS. Mr. Chairman, I agree with you.

Chairman PICKLE. It must be done.

Mr. GIBBS. I agree with you and I will be back with concrete plans in terms of recommendations.

Chairman PICKLE. Mr. Schulze?

Mr. SCHULZE. Thank you, Mr. Chairman.

Following up on that topic, when the test call is concluded are questions then asked about the individual? Is he told that this was a test call. Do you ask anything about his personal background or try to get a profile of the average answering individual?

Mr. GIBBS. Mr. Schulze, we try to give the feedback to the call sites with the calls that we are making in terms of the areas in which we ask the questions, what kind of responses we got, what the deficiencies were and so forth, because we think we are making enough calls that we are getting a pretty good idea across the call sites in terms of where the problems are likely to be. We are not singling out individuals, however.

Mr. SCHULZE. Is it done statistically or do you then give the name of the individual responding to the——

Mr. GIBBS. It is done statistically.

Mr. SCHULZE. It seems to me even though that it might make the employees a little nervous that it might be helpful if you include the name of the individual.

Mr. GIBBS. Well, let me mention——

Mr. SCHULZE. You may find that you have a small number of individuals who have not been trained up to the degree that they should be. Such person may be giving a statistically high number of incorrect answers and distorting the overall picture.

Mr. GIBBS. Let me mention on that count, each one of our managers monitors each of the people for whom they are responsible on a daily basis, in addition to the survey system.

Mr. SCHULZE. In other words, the manager will call some of the——

Mr. GIBBS. Pick up the phone. I did it the day before yesterday in Detroit. What you do is pick up the phone and you listen to the telephone conversation. If the manager determines that an incorrect answer is being given, we have a way to signal the assister. The other thing is that we use it to keep up with the people on an individual basis from the standpoint of the level of accuracy of their calls. We also use it as a training technique so we do have that capability, Mr. Schulze.

Mr. SCHULZE. What was the number of phone calls that you made, 20,000 or 15,000?

Chairman PICKLE. 15,000, you said.

Mr. GIBBS. Yes, 15,000 on the integrated test calls. We will eventually make 20,000.

Mr. SCHULZE. That does not include monitoring, I presume?

Mr. GIBBS. No, it does not. This is an entirely separate, first-year test call system.

Mr. SCHULZE. Do you remember how many GAO made?

Mr. GIBBS. No, sir, I honestly do not. About 2,000.

Mr. SCHULZE. About 2,000. I wonder, almost every local, weekly, or national news periodical I picked up in the last several months has been calling the IRS to determine the accuracy of their answers. Do you have any estimate of the number of extraneous phone calls you receive? It seems to me——

Mr. GIBBS. Mr. Schulze, this has become a way of life.

Mr. SCHULZE [continuing]. It would be somewhat humorous, but if you have 100,000 phone calls coming in that are just testing the system and it is difficult for the average citizen who wants to get

through to get through, we could turn those resources over to retraining instead of playing games with statistics.

Mr. GIBBS. Could I comment on that?

Mr. SCHULZE. The taxpayer would get a better deal in the long run.

Mr. GIBBS. Could I comment on that? One, our monitoring that we do in the sites does not affect anyone. With the 20,000 calls that we make, they are spaced out over a period of time, so we do not think we are really burdening the system. Remember, we have got 29 test call sites that we are calling over the entire filing season.

Let me tell you what I think our integrated test call survey system is eventually going to show. What I think it is eventually going to show is that you cannot place a limited number of telephone calls, and particularly if you are not giving full facts. What we are learning is that you must have a very broad number of call categories and you do what taxpayers really do in live conversations, who care about whether they are getting the right answer, instead of hiding the ball, instead of not giving the facts and asking the assister to drag out the facts. Taxpayers really do give them to us the facts in the live calls.

So what I am saying is I think we will show that the statistics we have been seeing are really not accurate in terms of what our overall accuracy really is.

Mr. SCHULZE. I also presume that the automated taxpayer service project, with its computerized display available, should change this to a large degree. Is that a correct statement?

Mr. GIBBS. That is our plan, that is what we expect, and based on what we have seen in some of the other countries that are using a system such as ours, it has worked very successfully for them.

Mr. SCHULZE. You stated that you were within 1 percent on processing returns. The numbers, of course, have increased by a few million each year and you later gave us a chart on that point. Even though the percentages are increasing, numerically are we about the same or are we going to have a flood of extensions. Would they come naturally in the area where there is a higher refund or a lower refund or a more complicated return? How about your thoughts on that?

Mr. GIBBS. Let me tell you what we are estimating this year. We have actually gone out and done a number of things for the first time this year. We are opening up lines of communications with practitioners and others to attempt to determine what we think the level of extension requests will be this year.

We are planning for as much as a 20-percent increase over last year. Last year, we had about 5.1 million extension requests. This year, we are projecting up to 6.2 million. To be honest, we really do not know at this point; that number is an estimate but it is based on a lot of work that we have been doing in terms of trying to get information about what we can expect.

Thus far, we really have not seen substantial extension requests, but then we usually do not until right at the end. Again, that is not going to impact our ability to get the money deposited and then process the refunds. It, of course, will impact our customers.

Mr. SCHULZE. Perhaps I have a different district from the chairman, but the talk—I do not ever talk in the bar rooms—at the

cocktail parties and political meetings I attend is that the general public in my district seems to feel that they are more concerned that they are paying a heck of a lot more money this year than they did last year. I do have a somewhat affluent district, and I have the feeling in the back of my mind that at the end of this filing season we are going to show a dramatic increase in the collection of taxes. When will we get an accurate picture of that?

Mr. GIBBS. We do have——

Mr. SCHULZE. The statistics do not show that.

Mr. GIBBS. No, they do not. We have——

Mr. SCHULZE. Unless you are just taking my constituents. [Laughter.]

Mr. GIBBS. Mr. Schulze, I do not think we are doing that. We will have information for you. We have projects set up so that we will be able to capture that information and make it available. I would hope that we would have it later on, perhaps as early as the summer, it may go into the fall. It just depends on how long it takes us—it frankly depends a little bit on what kind of extensions we do get, how long it takes people to file and then how long it takes to capture the information.

Mr. SCHULZE. A final question in this round. My time is expiring. On overseas compliance, I understand the avoidance percentage is fairly high. What can we do about that issue?

Mr. GIBBS. Mr. Schulze, we are finding a very interesting phenomena overseas. You know, we have discussed whether you can really do anything, and what the payback is for additional taxpayer service. We have been astounded with the response overseas to the taxpayer service that we are providing. We are having a number of people come in and not only file present year returns, but also file prior year returns. The response to the media and the information that we are providing is such that is one of the reasons we are asking for funding in next year's budget, because we really think that a large part of the problem over there is one of people not having correct information about their obligations.

Mr. SCHULZE. I presume the statistics bear out that where there is withholding, that there is no problem. But where the individual is a manufacturer's rep and is not withheld, that is where the problem is?

Mr. GIBBS. I do not want to paint too rosy a picture. You are absolutely right, from the standpoint of two things, one, withholding, and the other, sharing of information among countries with respect to investment and other types of income. That is extremely important for us in terms of getting the compliance from taxpayers that are out of the country.

Mr. SCHULZE. The reason I asked that question is I have asked the staff to look into this—to get some statistics, so if you have any other figures for us, we would be happy to have them.

Mr. GIBBS. We have some statistics and other programs that we are looking at right now where it appears that there are people who are intentionally attempting to avoid withholding when they are out of the country. That is also information that we can provide, if you would be interested.

Mr. SCHULZE. Thank you.

Thank you, Mr. Chairman.

Chairman PICKLE. Thank you, Mr. Schulze.

Now Mr. Thomas.

Mr. THOMAS. Thank you, Mr. Chairman.

I do not know about your district, but as I moved around at the Boys Scout meetings and the church prayer meetings, those folks were also paying a little more taxes. [Laughter.]

It is the busy season.

Mr. GIBBS. The busy season.

Mr. THOMAS. How many people in the hearing room work for the IRS? Let me see your hands. Be honest.

[A show of hands.]

Mr. THOMAS. Not that busy. I am really less concerned about accuracy as well. I want to pursue a point that Congressman Schulze made and I believe we should emphasize. To me, it does not make any sense at all to devise a quiz in which you attempt to stump someone over the phone with a question which is fairly arcane. If they get the easy ones, then you have a degree of questions which you might ask. I do not know the methodology in terms of the way in which you set it up.

But unless you have a quizzing technique which does model someone calling in and saying, "yes, but, yes, but, and, oh, yeah," that you always have a dialogue going on, you have a questioning of an answer and a reexamination possibly by the person asking it, then the questionee will ask a question as a follow on. That is a very difficult model for testing purposes.

I am far more interested in when you do find problem areas. How are you going to integrate that feedback in this new on-line tax service that you are going to start in Dallas in 1989 and carry it through 1991. I am far more interested in how you integrate the answers that you get than devising a model which produces a more accurate picture of your degree of accuracy.

Obviously, we want to do that, but it is more important to plug it into the system. Now just some reactions to your testimony. There seems to be a big reduction in itemized forms, schedule A with the 1040 this year. We can make it a lot higher if we increase the miscellaneous threshold of 5 percent, or jump to immediate elimination of the personal interest deduction. It is interesting from a reporting point of view.

On page 14 of your statement you have requested $2.7 million for a tax counseling for the elderly program. My opinion is that as you go through life, by virtue of the mistakes that you make, you eventually tend to get things right. One thing older folks tend to do is to have filled out a lot of tax forms, and although it may be a shifting tax form, they understand what a W-2 is. They understand what withholding is because they have followed the procedure. I am concerned about the first-time filers. The folks who do not know what a W-2 is, who really are not going to be successful in guessing the number of exemptions so that the amount withheld is approximately what their tax liability is.

You gave us a sheet on taxpayer services and you mentioned taxpayer education briefly, the young people's education. Is that $3.7 million covered in the $2.7 million?

Mr. GIBBS. No, it is not.

Mr. THOMAS. Where does that show up?

Mr. GIBBS. It basically shows up in the funding that we have for our understanding taxes program that we are taking—it is a part of Taxpayer Service, and I will be glad to give you that breakdown, Mr. Thomas.

Mr. THOMAS. Is that where the overseas taxpayers——

Mr. GIBBS. No, this will be in Taxpayer Service itself, and we can give you an actual breakdown for it—by the way, it is something that I personally had been working on with the Joint Council on Economic Education. We are trying to explain to our young people why we pay taxes, what our tax system is all about, begin to give them some training on the tax returns and so forth. When you do this, you are much more likely to have compliant taxpayers.

Mr. THOMAS. And they are accurate also.

Mr. GIBBS. That is correct.

Mr. THOMAS. Could you give me a little more precise breakdown of the category which is basically education information service in identifiable groups within your budget, the elderly as you have broken it out there? I assume you broke it out because you thought it was a positive. I am more concerned about problem areas like youth. I would like to see that breakout, as well as the overseas taxpayers, and non-English-speaking taxpayers, which is a problem in our area. No one discussed the number of telephoners who are bilingual, which I assume is mainly Spanish. It could be a problem, for example, in the San Francisco area, with about eight or nine different languages. It is very difficult to categorize, but it indicates how you are trying to meet the needs of specific groups. I get a lot of questions about that. I believe that is an outreach kind of a program.

Finally, Mr. Chairman, I have found also that it is always important to strive for accuracy. You are never going to get the percentage of accurate responses that you want, given the number of clearance problems. But you will have a lot less of a problem with an incorrect answer if the manner in which the telephone call is conducted, the effort expended and the attitudes remain with the taxpayers. Yes, they would like an absolute 100 percent answer, but if it is done in a way in which it appears that someone is trying to help them and that they have not been able to help them, at least you do not create a negative attitude. Yes, you still want the right answer, but I think the counseling aspect that you emphasized at the last meeting—and which I want to reemphasize it at this meeting—is that understanding that it is not an adversarial relationship. You are both in this together trying to work out the problem which makes a big difference. It is not just a yes or no, right or wrong. It is the manner in which the attempt is made that sometimes is as important but never as important as a right answer. A person likes to feel at least that the pursuit was worth it, rather than the drudgery. It is an area I know you are going to continue to exercise, but it does not always show up statistically. To the degree you can give us some feel for the improvement in that area, it will help at least for this member in the pursuit of 100 percent accuracy, which you are never going to achieve.

Mr. GIBBS. Mr. Thomas, could I comment on that, because I agree with you completely. There are several things that we did

this year. One, the statement on waiving penalties, I do not have the flexibility or the Service does not, to waive tax and interest.

What we are basically saying to the American taxpayer is, while we are going up the learning curve, if we make a mistake, you should not be penalized. That is one way of saying it. Another way is to emphasize to people on the telephone that we want them to take the time to work with the taxpayers and not simply process the calls on some artificial time basis, and the other thing we have asked for is courtesy this year.

Now, the marks that we have gotten back so far on courtesy and from the standpoint of the time that we are taking have been very high. I wish the accuracy rates were there as well, because, as you point out, it is still bottom line in terms of tax and interest that people have to pay. We recognize that.

Mr. THOMAS. Thank you.

Chairman PICKLE. Thank you, Mr. Thomas.

Before I recognize Mr. McGrath, Commissioner, what happens to an average taxpayer if he has a controversy with the IRS and there is a difference. He has claimed $20,000 more in refunds or deductions than the IRS agrees to and he will not pay and that is in controversy, and it goes on for a year or two and they cannot ever seem to settle it. Now, I guess penalty and interest are both going on, running? Is interest running on it?

Mr. GIBBS. If it is the taxpayer's mistake, then certainly interest and penalty would continue to run. What we have said is——

Chairman PICKLE. What is the mistake if he is claiming it and you want to prove your claim, and they both are still in controversy, and it goes on for 1 year or more. The interest builds up considerable, it gets worse instead of better, and it is not a question of mistake but he just will not agree with IRS, there is never any settlement on it, they just keep arguing and keep on appealing and so forth. It has not gone to court but it is still in controversy. Interest keeps building and it can get up to be almost double the amount of what the tax due was originally. Does he eventually have to pay that?

Mr. GIBBS. Well, it depends on whether he is eventually determined to be right or wrong.

Chairman PICKLE. Well, the IRS is not going to agree with him and he doesn't want to go to court. He will have to now, and now he probably wants to go to court, and even then the interest is running on it.

Mr. GIBBS. Well, he has some alternatives.

Chairman PICKLE. So the taxpayer really has either got to agree or he has got to pay up or——

Mr. GIBBS. No, sir, Mr. Chairman, I honestly do not agree with that. I mean there are a couple of things that taxpayers can do. One of the things that they can do is to simply make a deposit so that the interest stops, and if they are determined to be right, the money is given back to him. That is one way that they can do it to stop the interest running.

The other thing they can do is to stop dealing with us and immediately go to the courthouse, and if they wish to pay the tax they can do that.

Chairman PICKLE. I understand that, but most taxpayers are not going to go to court for all the expenses involved. He does not want to do it, but he could pay a deposit, and if he chose not to do that, then the controversy goes on, and eventually, if you do not budge, he has to cough up.

Mr. GIBBS. But only the——

Chairman PICKLE. Well, I have got a case in line I will give to you.

Mr. GIBBS. All right. Thank you, Mr. Chairman. It sounded that way. [Laughter]

Mr. THOMAS. Mr. Chairman, on that point, if the taxpayer does not pay up, he owes interest if he is wrong. I put a $20,000 deposit down, but what do you pay me if you are wrong?

Mr. GIBBS. We will pay you back the interest if it is a payment. If it is a deposit, no.

Mr. NELSON. If it is pre-petition, pre-litigation deposit, there is no interest rebate, which is something that we might want to talk about sometime about improving the statute. If it is post-petition, that is it is a docketed case in the Tax Court, interest does accrue in favor of the taxpayer.

Mr. THOMAS. You have said I am wrong on my filing and I have said I am right.

Mr. GIBBS. Yes.

Mr. THOMAS. We begin the process of negotiation. If I do not pay—say it is $20,000, if I do not deposit $20,000, your interest clock starts running.

Mr. NELSON. That is correct, from the due date of the return.

Mr. THOMAS. I put up the $20,000. Now, can I put up the $20,000 in an interest-bearing account?

Mr. NELSON. If you file a petition with the Tax Court and we——

Mr. THOMAS. No, we are negotiating with the IRS.

Mr. NELSON. Well, that is the point. If you are negotiating we are not permitted to pay interest on the deposit funds. It is in the nature of a security deposit. That is statutory.

Mr. GIBBS. That is because of the law. It is statutory.

Mr. THOMAS. Would you like the law changed in that area?

Mr. NELSON. I do not think it would be a bad idea at all, speaking for myself.

Chairman PICKLE. Well, we will have discussion on this point later.

Mr. GIBBS. The other comment, Mr. Chairman, I would like to make to clarify the record is that even in that instance, if the taxpayer is willing to make a payment and then file a claim for a refund, they can continue to negotiate with us and interest will run, even though that avoids the Tax Court. It means they may have to go into district court.

My point is if you feel strongly, there is a way to get interest if you want to put up the money.

Chairman PICKLE. I will submit some data to you on this.

Mr. GIBBS. All right.

Chairman PICKLE. Mr. McGrath?

Mr. MCGRATH. Thank you, Mr. Chairman, and thank you, Commissioner, for bringing your staff to this hearing.

I believe it has been somewhat unfortunate. First of all, it is unfortunate that the situation exists that either 20 or 25 percent or 40 percent, depending on whose numbers you believe, is the inaccuracy rate for information given by the Service. Unfortunately this must be a slow season for columnists, because it seems to me there has been more talk and more interest in this topic than all of the other aspects of the IRS combined. Let me congratulate you and your staff, particularly, Mr. Murphy, I saw him on Nightline and he extricated himself with great dispatch and dignity, and you, sir, on the McNeil-Lehrer Report. I believe you have done a great job, both of you, and your entire staff in explaining what is a very difficult situation this year because of the enormous change in the tax law. I believe the manner in which you conducted yourselves on these programs and the kinds of information that you are putting out has been helpful, particularly with the enormous number of complaints that I am getting from practitioners.

Back in Valley Stream, Rockaway Avenue, where I visit on Long Island, I do not hear too much from the individual type taxpayer to be honest with you. I guess it is borne out by the fact, as Congressman Bill Thomas said, that if we eliminate all of the deductions everybody could go to a EZ form. I would hope that they would not eliminate the State and local deduction. That would put me out of business.

I want to get some idea from you about where these complaints are coming from. I am getting them from the practitioners. One of the big problems that I get from them, aside from the complexity of the new law for businesses, is the fact that they just cannot get to a person in the Service who can give them an answer to their client's problem. I am wondering whether or not there is any consideration being given to establishing a contact person. A name that they can call who might be able to reach out and give them an answer. This is the biggest complaint that I get from the enormous number of practitioners on Long Island. The fact is that they get frustrated in not being able to get to somebone who can give them an answer without going to their Congressman to get the legislative liaison to get the answer for them. I am wondering whether or not that can be instituted.

Mr. GIBBS. Mr. McGrath, you are referring here to technical questions that they have about the law, where they are trying to prepare a return or——

Mr. MCGRATH. Something like that, say I guess some practitioner has negotiated the matter between the Service and himself for his client and they continue to get computer-generated letters saying that "we need this, we need that, we need this," and more bills and more adjustments even though the case already has been settled.

Mr. GIBBS. Let me comment about that specifically, on two levels. One is the short-term level, and that is this: In the 1989 budget, there is a request for additional funding for our problem solution officers, our taxpayer ombudsmen to deal with these types of problems where we have difficulty in getting to a conclusion or in straightening something out when something goes wrong within the organization. We are trying to expand their capability to handle problems. That is a fix-it on the back end when something goes wrong method. We recognize that we have got an obligation to

do that. That is one of the reasons we are requesting this kind of additional funding.

On another level, which is where we are really coming from with our quality improvement program, we are trying to address the problems on the front end so we will not keep having these kinds of problems come up and affect taxpayers and practitioners. What we are trying to do is to target particular problem areas and then go to work and get to the root causes of the problems within our own system, whatever they are, and try to come up with changes that we can make that will actually prevent these things from re-occurring. That is really where we are coming from. That is a longer term solution because usually what we find, Mr. McGrath, with these types of things, where notices keep coming out and so forth, there has been a problem. Oftentimes it is not a people problem, oftentimes it is one of our procedures or it is improper training, someone who entered something in the computer thought they had it done properly and it was not done properly. This is what we are trying to identify with our quality improvements.

Mr. MCGRATH. I had one Monday. I was in my District office and an older gent came in, probably in his seventies. He had received a letter from the IRS saying that he owed $70 on something or other. He paid the $70 without even checking whether or not he did owe it or not. Then he got back a letter saying that he owed $107 and he sent back something and said "I sent my $70," and he got back another letter saying now you owe $170. The guy is just out of his mind with frustration, because he does not owe a thing. There was a mistake in the first place because he did not owe the $70. The IRS has recognized that and seemingly the letters just continue to come.

Mr. GIBBS. I wonder if we could put him in contact with our problem resolution officer. I would be delighted if we could—that is what that function is for and it frankly has been very effective in terms of its acceptability and the enthusiasm by the practitioners and the taxpayers. It has been effective in addressing problems and I would be delighted to put our present Problem Resolution Officer in touch with your constituent.

Mr. MCGRATH. Well, we will do that. I believe we have already done it, but the fact is if some of these people who do the complicated returns were able to speak to somebody on the other end of the phone who could talk the same language to them, then perhaps a lot of problems could be settled before they either have fines levied or interest imposed or have to go to tax collection.

Mr. GIBBS. Could I mention one other thing that we are experimenting with. In a couple parts of the country. We have a dedicated telephone line in our Taxpayer Service area for practitioners which they can call if their clients have account problems. What we find is that those folks tend to be very responsible about how they call and the information that they have. We have been experimenting to see how that works, what kind of acceptability it has among practitioners to be able to call a specific number and actually talk directly about a client's tax problem. It is something that I hope to be able to expand.

Mr. MCGRATH. One last question, if I might, Mr. Chairman. What single complaint have taxpayers had, other than perhaps tax

practitioners on the elimination of ITC's? What single complaint egarding individual returns have you heard the most about in re-ationship to the administration of the new tax law?

Mr. GIBBS. Honestly?

Mr. MCGRATH. Honestly.

Mr. GIBBS. Change. They say it in different ways, but it comes ack to change the fact that basically they have difficulty with the orms and the rules changing each year.

Mr. MCGRATH. I heard you say on the McNeil-Lehrer Report that ou hoped that the Tax Code would not change for a number of ears because there have been so many changes over the last 6 or 7 r 10 years. I would hope that that would be the case, Mr. Chair-nan. We should not go ahead and change tax schedules, start new chedules or eliminate or reinstitute new deductions. We have enough confusion out there now in terms of practitioners being able to decipher what we have done over the last 10 years.

Chairman PICKLE. Thank you, Mr. McGrath.

Now, Commissioner, I have some other questions I want to ask ou. I am going a little slower than we anticipated and I know here are other witnesses to appear, Judge Sterrett and GAO, but et me ask you a question in the area of examinations. You sent a etter again this year to the Treasury saying that if you limited the examination program, that you did not believe that the bipartisan udget summit agreement revenue yield of $2.9 billion in 1989 could be met, and you said this, "We will need some 1,100 addition-al examination FTE positions and $45 million to secure it, the $415 million additional revenue needed."

Now, I ask you how many additional examination positions did you get, based on your appeal to the OMB?

Mr. GIBBS. With respect to the revenue initiative for 1989?

Chairman PICKLE. Yes.

Mr. GIBBS. Again, with the budget summit agreement, we did not receive any additional positions.

Chairman PICKLE. Are you saying that the first year you need 1,000 more positions right in this area, and yet you did not get any, you got none. Now, will you then achieve the budget summit tar-gets, with the resources provided in this 1989 budget?

Mr. GIBBS. One of the things that we were asked to do was to take a hard look at the estimates that we had made for the origi-nal 1989 budget several years ago, in light of the experience that we had in the examination area in terms of the dollars that we were producing in the last several years. We have had a greater return, it has taken us longer to audit the returns, but the average closure has been higher as a result of examining those returns, and we felt that it would be appropriate to add the additional amount in, based on our more recent experience. It is not——

Chairman PICKLE. My question, Commissioner, would you achieve this budget summit revenue level in 1989, based on the re-sources they gave you?

Mr. GIBBS. We believe we will, yes, sir.

Chairman PICKLE. All right.

Mr. GIBBS. Yes, sir, Mr. Chairman. I am sorry, I did not under-stand the question.

Chairman PICKLE. I doubt that you will, but we will check to see how that works out.

Mr. GIBBS. All right.

Chairman. PICKLE. Now, what justification did OMB give Treasury and IRS for the removal of this third-year and final installment of the revenue initiative in examination? You had the third year, and you did not go forward with the third year with a level of 1,100 people. What justification did OMB give you?

Mr. GIBBS. The justification we were given was that, based on the budget summit agreement that had been agreed to between representatives of Congress and representatives of the administration, that the revenue initiative was not necessary in order to achieve those levels, either on the outlay side or on the——

Chairman PICKLE. In other words, OMB took away the third-year examination level because they felt that they did not need the revenue?

Mr. GIBBS. No, sir, my understanding is that the——

Chairman PICKLE. Well, how are you going to say it, then?

Mr. GIBBS. Well, I am going to say it very simply, I understand that there has been an agreement reached between the representatives of the Congress and the representatives of the administration, and that agreement basically says that there is a certain amount of outlays in revenue that is to be expected and that is the thing that determines——

Chairman PICKLE. Mr. Commissioner, I want to give you a report here on the examination resources in which the OMB responds to why they did not get it, and when you cut through all the gobbledygook, they just said the budget summit did not require this extra revenue, we did not have to have it, and so we are going to do away with the third-year examinations, and that is what they did. Now, apparently that hurt you, because in your request to us now you show in processing in tax returns, if you had, say, 5,000 more slots or whatever level, you would put most of that in processing tax returns. So you are asking for that money back now, but you did not earlier this year just because OMB said we do not have to have it, so we are going to take it away from you, and if they did not use it, did they use the money anywhere else?

Mr. GIBBS. Mr. Chairman, I am sorry, I am just not understanding the question.

Chairman PICKLE. You had the third-year installment, the third-year examinations initiating, and they said you did not need it, we did not need the revenue, so that was just lost, so we do not have any revenue I guess to put anywhere, but you now say next year you are going to need that and please put it back. Is that in essence what you are saying?

Mr. GIBBS. I guess what I am saying at this point is this: We made the presentation to the OMB before the budget summit with respect to our 1989 budget, showing what we could do if we were given the additional resources. If the folks that negotiated the budget agreement, the folks in Congress and the folks in the administration decide that that is appropriate for some reason, then we would be delighted with it and we believe we will be able to produce the revenue with it.

Chairman PICKLE. All right. In the same area of examination, if you look at the trend of the examination policy over the past few years, there has been a steady decline of returns actually selected for audit. Now, in 1986 you projected 1.2 percent, in 1987 1.4 percent, in 1988 1.6, and in 1989 1.27. Actually, in those years, you had in 1986 1.1 percent, actually in 1987 you had 1.1 percent. Now, Mr. Commissioner, if this downward trend continues in 1989, the audit rate could fall below 1 percent. What is the impact of an audit rate of less than 1 percent on compliance?

Mr. GIBBS. What we have here, Mr. Chairman, is a competing need. One, what we have been told is that the way in which we perform our audits is every bit as important as the number of audits, and while I personally want to see the number of audits go up, I do not wish to sacrifice the quality of the audit itself, and what we are finding is that we are devoting our examination resources to more complex returns. They are taking longer and we are auditing fewer returns than we expected to audit, but as a result of the examinations we are also getting more revenue out of the cases that we are actually auditing, so by keeping the quality up, we are diminishing the number of returns that we are able to audit.

Chairman PICKLE. Why are you? Tell me in more simple language, why are you auditing less returns?

Mr. GIBBS. Because it is taking us longer to audit the returns that we are auditing.

Chairman PICKLE. Does that mean that you do not have enough examination resources, the very thing that the OMB cut out of you.

Mr. GIBBS. Well, Mr. Chairman, let us not get into it, because I think we are going to disagree over why that took place. By the same token, if we have more folks, then we obviously can perform more audits.

Chairman PICKLE. Well, when you say it takes as long, that means you do not have the personnel, that means you do not have enough people in the examination division, and OMB just said you do not need it and it took it out. What was the amount of the revenue of the third-year installment?

Mr. GIBBS. Well, the amount of the revenue in 1989, gross amount would be $1.1 billion, the cost would be about——

Chairman PICKLE. How much?

Mr. GIBBS. $1.1 billion in 1989, gross revenue that we thought we would produce with the revenue initiative that we requested last fall.

Chairman PICKLE. That seems rather shocking to me, that OMB would just say to you we do not need this revenue, we will cut it out and hurt your internal operations. I hope, Commissioner, you make a strong request for the replacement of those resources if you need them, and obviously you do, it ought to be done, because when you are auditing less than 1 percent, the average American, some of them may say my chances are 99 out of 100 that I will not even be audited. Those are pretty good odds.

Mr. GIBBS. Mr. Chairman, I would be delighted if the representatives of the Congress and the administration would conclude that they would fund the additional amounts of the——

Chairman PICKLE. Well, let me ask you another question. This is in the area of excise taxes, and particularly it pertains to diesel and gasoline taxes. Now, I have been concerned about the change in the point of collection on these gasoline taxes, and it seemed to me like we are putting an unfair burden on the businessmen on the enforcement of this area.

Now, I want to change the point of collection so that the market at least will make a direct remittance to the Treasury for gasoline. Now, my measure would not have changed the site of the point of collection and it would not have affected the time of collection. We tried to find out what it would cost and we could not get an estimate, but since we made no change in site collection and did not change the time, and because we had provided in there a qualification standard that they had to meet, we were told there would be no loss of revenue.

Then our committee talked down the street and they said, well, it might be $10 million in revenue, I do not understand how they arrived at that, but that is what they said, so then as we went forward, all at once Treasury says through IRS, or both, oh, it now costs $60 million. Now, I want to know why it would cost that much money, why would it be that much of an increase in collections? Can you tell me?

Mr. GIBBS. Mr. Pickle, I cannot. I am not familiar with those revenue projections.

Chairman PICKLE. I will get somebody to show them to you again. I will let you listen to him.

Mr. GIBBS. Let me suggest this. I will be happy to try to find out from the folks in the Office of Tax Analysis in Treasury why, but I honestly do not know.

Chairman PICKLE. Let me proceed then because I am concerned that when I try to get an estimate and they say, we do not think it would be—it would be very de minimis, $10 million. Then they come back with $60 million. And I bet you if I come again here and give you another 60 days, you will say it may be $100 million. I do not understand why it costs you a penny more, and I do not think you have any data.

I want to ask you this specifically. What would the Internal Revenue need in terms of additional resources in the 1989 budget to adequately monitor excise tax compliance? Specifically, what would it cost you to monitor gasoline and diesel? I would like to know how many excise tax returns did the IRS audit in 1986 and 1987; how many gasoline taxes and how many diesel taxes? Do you know, by chance?

Mr. GIBBS. No, but I will be happy to get that information and submit it to you for the record.

Chairman PICKLE. I want to know how that would compare, the examination of excise taxes and gasoline and diesel, how would that compare with corporate tax returns? How many, what percentage would that——

Mr. GIBBS. I do have some information that I can give you, if you would like to have it for 1986 and 1987.

Chairman PICKLE. You do not know how many excise taxes were returned last year?

Mr. GIBBS. For 1986, the returns examined for 1986 were about 18,246, and for 1987, about 17,000 returns.

Chairman PICKLE. Is that in the excise area?

Mr. GIBBS. That is in the excise area, yes, for gasoline and diesel.

Chairman PICKLE. If you have those figures, are those figures computerized?

Mr. GIBBS. Yes.

Chairman PICKLE. I have been advised that you do not even computerize your excise tax area, that you do not really have any data on it. I do not know where you are getting those figures except there are some more out-of-the-blue figures.

Mr. GIBBS. What I am basically told is this. Examination accomplishments for excise taxes are tracked on our Audit Information Management System, which is a computerized information system. This data is produced quarterly for each type of excise tax and includes such information as returns examined, hours per return, dollars per hour, dollars per return, percent of no change returns, inventory data and time applied information.

Chairman PICKLE. I do not think, Mr. Commissioner, that you pay very much attention to the excise tax in the area of auditing. I really do not believe you know who is being audited, and how much, and what quantity, from the information I received. Now I do not know how much we get in excise taxes, but I have a pretty good estimate that you probably collect around 80 to 90 percent of excise taxes. Customs will have some, and one or two other areas. But you get the bulk of it.

And we probably get in around $75 billion in excise taxes, and yet you do not have it computerized. And when we call down and ask you what it would cost if you made gasoline or diesel collection at the point of origin, say at market, you say, well, we do not really know, we think it would cost so much. I think you are just stonewalling it. I do not think you know.

Now if you do not know—and this is my own opinion—then what defense do we have up here when we try to move forward and my committee says, you cannot do this because it is going to cost me $60 million. I say that is a flimsy sort of an estimate, as far as I am concerned, at this point. Now I want something concrete that I can put my hand on.

Mr. GIBBS. Fine. While I am the Commissioner, we stand up and tell whatever the truth is. And for that reason, I insist upon being able to provide a response for the record.

Chairman PICKLE. You should have that chance and I accept that. But I want that information because I want to know how you actually arrive at that figure and why you just automatically said, we cannot do that because that would cost us around $60 to $100 million more. I think that is a guesstimation.

Mr. GIBBS. Fine, I will give you a response on that.

Chairman PICKLE. I have used my 5 minutes. I will come back with other questions.

Mr. Schulze?

Mr. SCHULZE. Mr. Chairman, I was not going to ask questions this round in the interest of time, but I have to say a few things.

As we were going through the 1986 tax reform I would repeatedly ask the Secretary of the Treasury as well as the Commissioner

of Internal Revenue, that if we took these actions how many fewer personnel would be needed at IRS because of tax simplification. And continually the response was, we are not going to need any fewer personnel. So I would say, how do we achieve tax simplification if we are increasing personnel all the time.

In that process I had offered some amendments which would lead to genuine simplification of taxation, which probably would have led to——

Chairman PICKLE. In forms?

Mr. SCHULZE. No, in the type of collection, if the gentleman will remember, some options. One was a national consumption type tax and another was a form of tax simplification of lowering and flattening the tax. The response to that was, no, the time had not come.

As we go through this exercise every year, we posture—it is almost like a mating dance. You do not have enough personnel, and OMB is the bad guy, and we are going to increase. We do go through this every year.

I just hope that some time we would genuinely look for tax reform. And in response to Mr. McGrath's line of questioning earlier, that we would like to have 5 or 10 years with no tax changes. I hope for that, but there is no way that is going to happen. As we make this thing more complicated with every tax reform, eventually the people are going to rise up and say, look, even though we live in a complicated society, there are simplifications which we can make and should make. I would just hope that someday we can get to that.

I really do not have a question, but I was just prompted to make that statement, Mr. Chairman. Thank you, and I yield back the balance of my 5 minutes.

Chairman PICKLE. I will now yield to Mr. Dorgan. Mr. Dorgan, do you have any questions?

Mr. DORGAN. Yes, I do, Mr. Chairman.

Chairman PICKLE. Mr. Dorgan.

Mr. DORGAN. Thank you, Mr. Chairman. I have been testifying at two other committees this morning and have been necessarily delayed, but I trust that everything has gone well. When I walked in, I saw that it was going very rapidly.

Let me ask the Commissioner, if I might, a couple of questions. I am interested especially in what the Internal Revenue Service originally believed it needed to do its job and how the Office of Management and Budget reacted to that. We have this shadow government in America called OMB that oversees everything.

There is often a judgment interposed between those who think they know something about a subject and then the layer in between, which is OMB. I would like to explore some of that, if I might with you, Commissioner.

I would like to go over examinations. I would like to know what the Internal Revenue Service request was on positions for examinations in the budget that you submitted to the administration.

While you are looking for that number, the point I am making is that the old 2.5 percent audit rate which has dropped to around 1.1 percent. What kind of recommendations are built into these budgets to try and improve in that area of compliance and enforcement

by increasing the examination and increasing the number of examiners?

Let me mention the several other areas I would like to explore: The requests that you have made on appeals and litigations, the number of positions, collections and taxpayer assistance. If I could ask about those four areas and get some indication from you what your request was from the budget standpoint, and then what the Office of Management and Budget decided to do.

Mr. MURPHY. Mr. Dorgan, let me respond to your question about the examination coverage. The desire to improve coverage of examination is something that the Service has been aware of for a long time. And in the third year that did not go forward, there was a plan to increase that coverage from 1.27 to 1.32 percent. That would have produced 66,000 additional examinations.

As the Commissioner testified earlier in responding to the chairman's question regarding the summit meeting where it was decided not to go with the third leg of the revenue initiative, that opportunity to go from 1.27 to 1.32 just did not take place and it is not in this budget.

Mr. DORGAN. I understand that. The number of positions that the Internal Revenue Service requested of Treasury, as I understood it, in the examination area was 5,000 positions, and the Office of Management and Budget, as I understand it, cut that to 500 positions. Is that generally true?

Mr. GIBBS. Let me give you the—we submitted a revenue initiative last fall to the Treasury and to OMB. The total revenue initiative, which included the examination personnel and resources as well was about 6,800 average positions, and it would have a cost of about $286 million. We estimated that for fiscal 1989, it would return gross about $1.1 billion and another $2.2 billion in 1990.

If you would like, I can go through what comprises the 6,800 positions and so forth. But that gives you some idea at least of the overall revenue initiative that we had proposed in terms of its cost and what it would produce in 1989 and 1990.

Mr. DORGAN. Let me then just briefly, Commissioner, say that my understanding was that in examinations you requested generally 5,000 positions and received 500; and appeals and litigation about 600 positions—slightly more—received two; in collections, 3,000 positions, received 45; in taxpayer assistance, 400 positions and not only did you not receive the 400, you received a reduction of 32 positions.

The reason I ask the question is to try to understand the difference between your assessment of the resources you need to do your job and the assessment that Jim Miller or one of his folks down at OMB makes about what kind of a job ought to be done. The assessment they make at OMB might be radically different from the assessment that we would make as Members of Congress or you would make as Commissioner.

It is important for us to see what happened between you and your request and the OMB. That is the reason I asked the question, in order to get on the record the substantial difference between what you perceive is needed to do the job in both enforcement and assistance, and what the Office of Management and Budget per-

ceives is necessary. Frankly, I am not impressed by the Office of Management and Budget.

Mr. GIBBS. Let me just describe basically what happened to the proposal that we made. The basic reduction that we experienced in what we proposed was in the revenue initiative. That is where the bulk of the personnel resources and dollars are. As I have explained previously, what I was told was that because of the budget summit agreement which specified outlays as well as revenues, and that was agreed to by the administration and Representatives of Congress, that what we were proposing simply was not necessary from the standpoint of the targets and also from the standpoint of the additional outlays.

The next major amount was that there were some funds that we have proposed for data processing modernization that were deferred. We were given a substantial portion of what we asked for; 90 percent of the budget we asked for, we got from OMB. But there were, as you indicated—your figures are correct in terms of what we did not get. Those are the two principal items in terms of what we did not get in the 1989 budget.

Chairman PICKLE. Would you yield on line with that question?

Mr. DORGAN. Yes.

Chairman PICKLE. You said you got 90 percent. Overall that may be the correct figure. But in the areas of appeals and tax litigation, you got two extra people and that is all. You requested 662. That is not any 10 percent difference.

Mr. GIBBS. Mr. Pickle, I understand that. What I was referring to—again, the reason for that is that is tied right into the revenue initiative. If we had received the revenue initiative, we would have received those personnel.

Chairman PICKLE. But you did not get the revenue because OMB took it away from you, in effect. So you do not have the revenue. And I just say, it comes back to accounting in areas, and you cannot do your job if you do not get what is requested.

Now you cannot get 100 percent of everything that you want in every area. Maybe you ought to. You are a moneymaking audit machine down there if it functions properly. But at the same time, it just seems to me that on the face of it, it looks like you are not getting anywhere near what you ought to in this.

Let me go one bit further because I want to quote this to you and I want you to comment. It is still in line with the same question.

One section of the Tax Code requires separate reports from both the Internal Revenue Service and the Tax Court indicating the action taken to deal with the Tax Court inventory of closing cases efficiently and on time. Congress believed that requiring periodic reports would keep it apprised of the measure that both the IRS and the Tax Court have taken to reduce the Tax Court inventory. The reports are due to every 2 years beginning in 1987.

The Tax Court provided their report to Congress on February 4, 1988. Where is the IRS' report and why it is taking so long for the Service to provide the information to Congress?

Mr. GIBBS. Mr. Pickle, if I could, I would like to ask our chief counsel, Will Nelson, to give you a response.

Chairman PICKLE. All right, Mr. Nelson, we would be glad to hear from you.

Mr. NELSON. Mr. Chairman, there was no date other than this year for the delivery of that report. We are working on that report.

Chairman PICKLE. Why would it take you until now, after 1 year or 2 or so——

Mr. NELSON. Let me continue, if I may. As you probably are aware, the Office of Management and Budget proposed or suggested that we consider adopting a privatization initiative with respect to disposition of tax controversy inventory. And it seems to us that the first thing we ought to do is respond to that inquiry and that request and see if we do think that there is a place for privatization in this process before we respond to another report.

Chairman PICKLE. I tell you, there is not.

Mr. NELSON. In any case, what we are working on right now is to try to provide a report to OMB with respect to privatization, which we will delivery shortly. We will be getting this report to you. It will not be the end of the year. It will be a couple more months.

Chairman PICKLE. Thank you.

Mr. Dorgan, go ahead.

Mr. DORGAN. Just to continue, as I understand, Commissioner Gibbs, your answer, the position of the Office of Management and Budget is that we did not need the revenue, or at least, based on some agreement, the revenue was not necessary. OMB decided that we should not make the investment because we do not need the money.

Mr. GIBBS. That is what I have been told.

Mr. DORGAN. They ought to have their collective heads examined down there. Who in Washington that lives and breathes and reads the newspaper and understands our fiscal policy really thinks that we do not need the money? You probably do not want to answer that. [Laughter.]

The point, Mr. Chairman, I simply wanted to make and I think you have made very well is that while no agency ought to get carte blanche authority to request and receive all the people they think are necessary to do their job, it is important, given the charge that you have received from many areas, including this committee and a task force that I was involved with, to understand what you believe is necessary and what OMB is willing to allocate to do that job.

If we are serious about narrowing the tax gap, better enforcing our tax laws, asking those who are now freeloading to pay their fair share in deference to all the honest taxpayers, then we have to be serious about making the right kind of resource investments in appropriate enforcement and assistance areas. That is why it is important for the Ways and Means Committee to understand your analysis of what those right investments are, your analysis of what levels those investments should be, and who has imposed a different judgment and why.

Again, I appreciate having that information on record. I yield back the balance of my time, Mr. Chairman.

Chairman PICKLE. Mr. Gibbs, I want to say with respect to the last series of parries we had here, I had sent you a letter in April in 1987 asking about the report on the Tax Court and asked you to have your report into us by February of this year. Apparently, we have not heard that, so I wish you would check your records and

give us a response on it. We will be hearing from the Tax Court in just a minute.

Mr. GIBBS. I will, Mr. Chairman.

Chairman PICKLE. Now I have a lot of other questions which we are going to submit to you, but in the interest of time here I want to go to some of these other witnesses. And I hope if you have to leave, that Mr. Nelson or some of the other people, Mr. Murphy, can stay.

Mr. GIBBS. We will stay, Mr. Chairman.

Chairman PICKLE. In case some other questions are raised on this thing.

Now on a more pleasant note. I think this committee is impressed with the emphasis that you are putting on taxpayer services. In my district, I sense a very definite upbeat attitude among individual IRS employee, wanting to give service and inviting the public to come in by various means. Some of the local television stations are running little features saying, the Internal Revenue Service urges you to come out, and they will have somebody here at this office for so many hours today and all this week for assisting taxpayers.

That is good. Keep that emphasis up because that can bridge the gap of distrust, or at least acceptance of the fact that we have to pay taxes. It increases acceptance of the voluntary tax system. I hope you keep that up.

I do say that we have got serious questions. If you are going to need extra supplemental funds, I want you to take the initiative and tell us. We have always tried to help. We have got to try to be prepared in our request to the Appropriations Committee. We are going to make our report and we want to work in tandem or in support of whatever you are asking us.

But we have to ask you to try to be the judge of what you need and what you want, and we cannot let OMB run our operations. They play a vital part, sometimes too vital, but I want you to tell us what you need as we go forward. If so, I believe that next year can be a good year.

You do not have any problems in the computer system, so I am encouraged about that. Your returns are up to date as far as last year is concerned. You do need more enforcement staffing for litigation, and processing of returns, and we must get those extra people over there for you.

Does any other committee member have any questions at this point?

Mr. DORGAN. Let me simply, Mr. Chairman, echo your sentiments. I think Commissioner Gibbs has turned a long, long corner here and is attempting to do a good job in enforcement and assistance. I have asked on previous occasions if he would consider some pilot programs on some special taxpayer assistance initiatives, which he has indicated he would be willing to do. But I think the entire committee recognizes a new effort and a new spirit of cooperation, and we appreciate that, Mr. Commissioner.

Mr. GIBBS. Mr. Chairman, members of the subcommittee, I would simply like to say this. One of the things we are recognizing—and when I say we, I mean Mr. Murphy, Mr. Weddick, Mr. Brennan, Mr. Nelson and myself, and the other folks that 1 minute ago in

this room raised their hands in terms of working for the Internal Revenue Service—is this, in order to get the voluntary compliance that we want and need, we are going to have to go out and earn the respect and confidence of the taxpaying public. We earn it every day on the compliance side of the organization and also on the service side of the organization.

We have got a long way to go and we understand that. But in terms of what we are about in our organization, we are pretty darned enthusiastic about the changes that are being made. And we particularly appreciate the assistance and support that this subcommittee has given us.

Chairman PICKLE. Mr. Gibbs, thank you very much, and thank you for your assistance.

[Questions addressed to the IRS and their responses follow:]

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

COMMISSIONER

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Ways and Means
Subcommittee on Oversight

The Honorable J. J. Pickle
Chairman
Subcommittee on Oversight
House Ways & Means Committee
Washington, DC 20515-6350

Dear Mr. Chairman:

This is in response to your letter of April 15, 1988 in which you asked several follow-up questions to the April 13th hearing on the 1988 filing season and IRS' FY 1989 budget request. Enclosed is our complete response to the questions that you raised.

We appreciate the efforts of your Subcommittee on our behalf. If your staff has further questions, please have them contact Gayle Morin, Director of our Legislative Affairs Division, on 566-6070.

With kind regards,

Sincerely,

Enclosure

PROPOSED FY 1989 STAFFING CONVERSIONS

Question 1a: Under the proposed FY 1989 budget, how many temporary employees are scheduled to be converted to permanent employees?

Answer: In the proposed FY 1989 budget, there are no provisions for converting temporary employees to permanent status.

## CONVERSION OF TEMPORARY TO PERMANENT EMPLOYEES

Question 1b: What costs are associated with conversion of a temporary employee to a permanent employee, including the increase in salary, benefits and other related costs?

Answer: Conversion costs depend on the employment category; that is to say, a significant change in grade would have an equivalent effect on costs. In this instance Taxpayer Service Representatives, both permanent and temporary, earn the same salary and benefits. Conversion costs, therefore, would be incremental.

For example, the rise in salaries/benefits would be attributable to with-in grade increases. The operating travel increase would occur because permanent staff need to travel to balance the workload in Taxpayer Service. An instance where a representative in Baltimore is asked to go to Wheaton to assist that office would be an example. The chart below shows where cost increases would occur:

| | Cost Increases |
|---|---|
| Salaries/Benefits | $ 648 |
| Operating Travel | 481 |
| Indirect Printing | 323 |
| Comp Equip Maint | 73 |
| Off Auto Equip | 575 |
| | $2,100 |

As the chart indicates, converting temporary Taxpayer Service Representatives to permanent positions would cost the Service $2,100 per conversion. Combining the costs per employee with the number of conversions provided in question 1(c) below, the total cost of conversion would be $2,940,000.

## POSSIBLE CONVERSIONS FROM CURRENT PROJECTIONS

Question 1c: With the current projected workload for FY 1989, how many temporary employees could be productively converted to permanent employees?

Answer: We will be reviewing this situation to determine the number of employees who could be converted productively. However, as a start to this process and if favorable circumstances permit a reallocation of resources, we plan to convert approximately 700 employees during the balance of FY 1988 and another 700 employees in FY 1989 for a total of 1,400 by the end of FY 1989.

## UPGRADING POSITIONS IN TAXPAYER SERVICE

Question 1d: Under the proposed FY 1989 budget, how many Taxpayer Service Representatives could be upgraded to Taxpayer Service Specialists? What grade structure changes are possible within the proposed budget?

Answer: In the proposed FY 1989 budget, no provisions are included to upgrade Taxpayer Service Representatives (TSR) to Taxpayer Service Specialists (TSS). However, our long range goal is to upgrade 1,000 TSR positions to TSS staff in FY 1989, if under favorable circumstances, resources become available for reallocation.

## COSTS ASSSOCIATED WITH UPGRADING TAXPAYER SERVICE REPRESENTATIVES TO TAXPAYER SERVICE SPECIALISTS

Question 1e: What costs are associated with the conversion of a Taxpayer Service Representative to a Taxpayer Service Specialist?

Answer: This question is similar to your previous one, except that in this instance there is a salary change. Converting permanent Taxpayer Service Representatives (TSR) to Taxpayer Service Specialists (TSS) would cost the Service $5,118 per upgrade. Again, charts are provided to show exactly where costs would be incurred.

| | Upgrade |
|---|---|
| Basic Salary | $3,560 |
| FICA | 216 |
| FEGLI | 14 |
| Medicare | 52 |
| FERS | 527 |
| Operating Travel | 158 |
| Training Travel | 533 |
| Training-Cont Svc | 38 |
| Training Supplies | 20 |
| TOTAL | $5,118 |

Taking the information provided by question 1(f) below, it would cost $5,118,000 to upgrade the 1,000 Taxpayer Service Representatives to permanent Taxpayer Service Specialists.

## CONVERTING TAXPAYER SERVICE REPRESENTATIVES TO TAXPAYER SERVICE SPECIALISTS FROM CURRENT PROJECTIONS

**Question 1f:** **With the current projected workload for FY 1989, how many Taxpayer Service Representatives could be productively converted to Taxpayer Service Specialists?**

**Answer:** **We are analyzing the Taxpayer Service Representative (TSR) and Taxpayer Service Specialist (TSS) staffing to determine the optimum mix for our operations. As a starting point, we intend to convert 1,000 TSR positions to TSS staff in FY 1989 if, under favorable circumstances, resources become available for reallocation.**

Question 2: With regard to resources to improve training in the areas of Taxpayer Service and Adjustment Correspondence, IRS indicated that recruit training estimates "...are developed some two years prior to submission of our budget to the Congress and some of the improvements we are making were not considered when developing the FY 1989 budget."

a: In each category, by what amount do necessary training costs exceed the amount included for such training in the FY 1989 budget?

Taxpayer Service

Improvements in the training courses for Taxpayer Service have already been implemented within the limits of the FY 1989 budget request. However, to continue these improvements the IRS would expand the on-the-job training for new tax assistors. In the past, the recruits were sent home after completing their training and called back for duty as the filing season went into full swing--a three month lag from classroom training. During this past filing season, we retained many of the recruits rather than furlough them, enabling them to gain hands-on experience in responding to taxpayer inquiries with close supervision by experienced assistors prior to peak periods. We are finding that this provides time for the new assistors to fine-tune their weak spots, especially in communication skills which cannot be taught so much as learned from experience. We also expect that retaining these recruits without furlough will reduce our turnover rate. Continuing this program in FY 1989 would cost the IRS $5 million (350 FTE's) and would have to be reallocated from what has been included in the FY 1989 budget request.

Adjustments Correspondence

As with Taxpayer Service, improvements have already been made to the classroom training course that are within the FY 1989 budget proposal. The IRS believes that improvements can be made by increasing the number of more experienced personnel who can work with new recruits in providing on-the-job training. By changing the mix of staffing in Adjustments Correspondence to more front line managers and more experienced personnel, new recruits during on-the-job training would receive more personal attention. This effort in FY 1989 would cost the IRS $5.3 million (150 FTE's) and would have to be reallocated from what has been included in the FY 1989 budget.

In addition, since the FY 1989 budget submission, our proposed workplan indicates that our training efforts for Adjustments Correspondence personnel would require an additional 52 FTE's (at a cost of $844,000) for that function in the service centers. The high turnover rate in this particular function necessitates frequent training classes for new recruits. The additional staffing would be used to replace personnel who are in training. In other words, additional staffing would have to be reallocated to make up for the recruits who are attending training.

b: In addition to the funding of recruit training, how much funding is provided in the FY 1989 budget proposal to retrain or update the training of current employees in each category?

Both Functions

Due to the way the budget is developed, it is not possible to break out the exact amount that is budgeted for post recruit training. Although there is an amount for post recruit training factored into the estimates for training overall, the exact amount by function is not available.

c: What costs are associated with retraining or updating the training of current employees, in each category, which are not provided in the FY 1989 budget?

Both Functions

There are no identifiable costs for post recruit training that are not included in the FY 1989 budget.

**Question 3: How would the IRS allocate additional funding for non-revenue producing activities, and specifically training activities, over the proposed FY 1989 levels at each of the following levels:**

**(a) $10 million**
**(b) $25 million**
**(c) $50 million**
**(d) $100 million**
**(e) $200 million**

**Answer: The Internal Revenue Service would allocate additional (non-staff) funding to cover funding needs in four areas. The four areas, in priority order, and the related funding needs are as follows:**

| | | Cost in Millions |
|---|---|---|
| I. | Unavoidable Costs | $ 60.7 |
| II. | Quality Improvement Efforts | $ 21.0 |
| III. | Retention and Recruitment Measures | $ 11.6 |
| IV. | Automated Data Processing Initiatives | $ 45.0 |
| | Total | $138.3 |

**A detailed breakout of each area is attached on the following pages.**

I. Unavoidable Costs

| | | |
|---|---|---|
| A. | Cover recent (April 87) postal rate increase. | $ 17.7 M |
| B. | Fully finance proposed 2% pay raise - Total (52.4) in Budget (23.3) | $ 29.1 M |
| C. | Special salary rates already approved for revenue agents in New York City. | $ 1.4 M |
| D. | Motor vehicles replacement supplies and other GSA stock items (overhead charges resulting from GSA industrial funding program). | $ 5.4 M |
| E. | Printing and Postage related to Tax Reform Act. | $ 7.1 M |
| | | $ 60.7 M |

II. Quality Improvement Efforts

| | | |
|---|---|---|
| A. | Conversion of TSR's from temp to perm<br>$2,100 x 1,400 | $ 2.9 M |
| B. | Upgrading TSR's to TSS's<br>$5,118 x 1,000 | $ 5.2 M |
| C. | Additional Resources<br>( To improve customer service<br>See Question #2 above)<br>TPS - $5.0 M + 350 FTE<br>RPA - $5.3 M + 150 FTE | $10.3 M |
| D. | Service Center additicnal conversion of Temporary to Permanent - 1240 positions | $ 2.6 M |
| | | $21.0 M |

| III. Retention & Recruitment Measures | | Cost |
|---|---|---|
| A. | Pay transportation and travel to first Post of Duty for newly hired IR agents | $ 2.6 M |
| B. | Implement on-site child care programs in 13 IRS offices | $ 1.3 M |
| C. | Implement selected management training programs | $ 3.1 M |
| D. | Implement Health Improvement programs in 15 IRS offices | $ 1.3 M |
| E. | Implement employee counseling programs | $ 3.3 M |
| | a. alcohol, drug abuse<br>b. career<br>c. financial<br>d. relocation<br>e. traumatic incident | |
| | | $ 11.6 M |

| IV. ADP | Cost |
|---|---|
| Selected ADP and systems modernization initiatives | $ 45 M |

Question 4: In response to Subcommittee's question on how the IRS would allocate additional staffing over the proposed FY 1989 levels, you responded only with regard to additional staff allocation in the area of revenue-producing programs. Are revenue-producing activities the only activities where IRS would allocate additional staffing of up to 5,000 positions over the proposed FY 1989 levels? How would IRS allocate additional staffing at each of the following levels to programs which firstly, are not revenue-producing, and secondly, are both revenue producing and not revenue producing:

(a) 500 additional staff?

(b) 1,500 additional staff?

(c) 3,500 additional staff?

(d) 5,000 additional staff?

(e) What would be the yield-to-cost ratio at each level?

Answer: Revenue-producing activities are not the only activities where the Internal Revenue Service would allocate additional staffing of up to 5,000 positions over the proposed FY 1989 Levels.

The Internal Revenue Service would allocate additional staffing of up to 5,000 positions between non revenue producing activities and revenue producing activities in the following fashion:

| Activity | Cost (in millions) | Average Positions | Yield Cost 89 | Yield Cost 90 |
|---|---|---|---|---|
| I. Perform both tax related and wage discrepancy reconciliation work in cooperation with Social Security Administration | $ 7.4 | 225 | | |
| II. Improve the quality and accuracy of taxpayer contacts | $ 19.3 | 463 | | |
| III. Implement automation of Federal Tax Deposit activity and Tele-TIN program | $ 7.2 | 194 | | |
| IV. Fund Third Year Exam Rev Int | $148.0 | 3,302 | 2.3 | 5.8 |
| V. IRP (Non-Filer) | $ 7.8 | 184 | 11.3 | 16.2 |
| VI. Accounts Recievable Intiative | $ 17.8 | 426 | 4.2 | 7.0 |
| VII. Fund District Office Automation | $ 4.6 | 206 | | |
| | $212.4 | 5,000 | | |

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April 26, 1988

The Honorable Lawrence B. Gibbs, Jr.
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Dear Commissioner Gibbs:

I want to thank you for your testimony at the Subcommittee on Oversight's hearing to examine the Administration's Fiscal Year 1989 budget proposals relating to the Internal Revenue Service and the United States Tax Court. To complete our hearing record, I would appreciate receiving your responses to the following questions by the close of business, Friday, May 13, 1988:

1. Has the IRS needed to reprogram or redirect resources since submission of the Administration's FY 1989 budget? If so, does this create or indicate a problem for next year which the IRS FY 1989 budget request does not address?

2. How much will postal expenses increase for both FY 1988 and FY 1989 as a result of the April 3, 1988 postal rate increase? From which function(s) will funds be taken to absorb this expense?

3. There has been a steady decline in the percentage of tax returns which IRS projects will be audited in recent year budget submissions and the actual audit coverage achieved in those years.

   (a) Why is IRS not auditing as many returns as are projected in the annual budget submissions to Congress?

   (b) Are there too few resources in Examination or is this the first place from which resources are taken to solve problems in other functions?

   (c) What measures do you think can be taken to compensate for the decline in the audit rate?

4. Under the Administration's FY 1989 budget submission, the Automated Examination System will receive only $1 million in additional funding next year.

   (a) What are the benefits of the Automated Examination System and what is the benefit-to-cost ratio?

   (b) Why is the increase requested for FY 1989 so low?

   (c) When will all case examiners and tax auditors have desk top computers?

   (d) When will all revenue agents get direct access to the court cases and research in the citator system?

5. The estimated inventory of Tax Litigation continues to climb in FY 1989; yet, the Administration's FY 1989 budget submission requested only 2 additional positions.

   (a) Why are both the non-docketed ending inventory for Appeals and the docketed ending inventory for Tax Litigation increasing in FY 1989?

   (b) How much would the ending inventory levels have improved under the FY 1989 budget which IRS submitted to Treasury requesting 662 additional positions?

6. What will be the impact on employee moral and turnover if, as projected, the Tax Court and refund case receipts increase by 5,000 and there is no increase in the staff level in FY 1989?

   (a) What efforts are being made by the IRS to retain qualified personnel?

   (b) Can the IRS continue to compete in the market place for able tax professionals?

   (c) If the current level of attrition for experienced employees continues, what impact will the Administration's proposed FY 1989 staffing level have on the IRS' ability to manage the increasing workload?

7. What is the IRS's position and views with regard to the Administration's FY 1989 budget policy initiative for the privatization of proposing tax dispute arbitration?

8. The IRS expects the number of employee plan determination letters to increase by 50 percent in FY 1989. How can a 1 percent increase in the staff handle the increased workload?

9. Under the Administraton's FY 1989 budget submission, how many additional agents will be committed to money laundering investigations?

10. The accounts receivable inventory, as of the end of February 1988, was $53.5 billion compared with $46.2 billion a year earlier. Collections from accounts receivable in FY 1989 will increase by only $1.2 billion over the FY 1988 level.

    (a) At the Subcommittee's FY 1988 budget hearing last year, you indicated that the IRS would be completing its study of the accounts receivable inventory this Spring. When will your findings be complete? Based on your findings to date, what is your estimate of the portion of the accounts receivable inventory which is uncollectable?

    (b) What resources in the Administration's FY 1989 budget submission will be devoted to reducing the accounts receivable inventory? To what extent will collection activities in FY 1989 reduce the accounts receivable inventory?

    (c) How much money is being lost annually due to expiration of the statute of limitations? How many delinquent accounts are represented in this revenue loss?

11. Suggestions have been made to allow taxpayers to use credit cards to pay their tax liabilities.

    (a) Has the IRS discussed the components of the two-year pilot program suggested at the end of February 1988 by OMB? If so, please explain the program.

    (b) What are the advantages and disadvantages of such a program? What is IRS's views and position with regard to such a program?

    (c) If necessary legislation was adopted, how long would it take for the IRS to implement this program? What would be the cost to the federal government?

(d) What has been the outcome of IRS discussions with credit card companies?

12. IRS's FY 1989 budget submission to Treasury requested 463 more positions for Taxpayer Service than OMB included in the Administration's FY 1989 budget submission. What services could have been provided under IRS's proposal which will not be provided under the Administration's FY 1989 budget submission?

13. IRS's FY 1989 budget submission to Treasury requested $4.8 million for the Automated Taxpayer Service System. Only $2 million was included in the Administration's FY 1989 budget submission. What will not be done under the Administration's budget request which IRS would like to do in FY 1989?

14. The Administration's FY 1989 budget submission increases the number of positions in Returns Processing and Computer Services; however, IRS's FY 1989 budget submission to Treasury requested an increase which was three times larger.

(a) What will be the impact of the Administration's failure to approve IRS's requested level of additional resources?

(b) Why did IRS request 3,700 more employees for FY 1989 than were authorized for FY 1988?

15. GAO reported to the Subcommittee that there are serious problems with the quality of IRS's handling of taxpayer correspondence. What resources in the Administration's FY 1989 budget submission will be used to improve the quality of correspondence at the Service Centers? What additional resources are necessary to improve the quality of correspondence which are not provided in the Administration's budget request?

16. The Subcommittee continues to be concerned about the accuracy of IRS's responses to both telephone inquiries and correspondence.

(a) How are production standards and/or quotas used by the IRS to measure employee performance in those areas?

(b) What consideration is being given to the impact of performance standards which emphasize quantity, and not quality, on the accuracy of IRS's responses to telephone inquiries and correspondence?

17. Is the IRS seeing more taxpayer errors or returns processing errors in the error resolution inventory during the 1988 filing season, in comparison to the 1987 filing season? What percentage of the error resolution inventory is comprised of returns processing errors?

18. The Subcommittee was recently contacted by an accounting firm and informed that the IRS has significantly limited the number of tax forms given to tax practitioners. The firm specifically referred to bulk order requests for employer payroll tax quarterly forms (Form 941).

    (a) What is the IRS's policy, and reason for such policy, with regard to bulk orders for tax forms?

    (b) Does the IRS limit the number of forms supplied to tax practitioners? If so, why?

As always, your attention to this matter is greatly appreciated.

Sincerely,

J. J. Pickle, Chairman
Subcommittee on Oversight

JJP/sal

Question 1: Has the IRS needed to reprogram or redirect resources since submission of the Administration's FY 1989 budget? If so, does this create or indicate a problem for next year which the IRS FY 1989 budget request does not address?

Answer: Reprogramming adjustments to deal with changing circumstances are typically necessary since budget estimates are initially prepared many months in advance of the fiscal year. The service has made a major effort to give taxpayers a smooth and successful filing season in this year of tax reform. Pursuing this objective requires that we make resource adjustments under established reprogramming guidelines.

Sources of funds for the additional resources for tax processing and taxpayer service included redirections of funds from delayed ADP projects, communications and other support areas.

At this time, we do not foresee next year (FY 1989) entailing additional workload in returns processing or taxpayer service resulting from tax reform.

POSTAL RATE INCREASE

QUESTION 2: How much will postal expenses increase for both FY 1988 and FY 1989 as a result of the April 3, 1988 postal rate increase? From which function(s) will funds be taken to absorb this expense?

ANSWER: The Service will have to allocate $5.1 million in FY 1988 and $17.1 million in FY 1989 to cover increased postal expenses resulting from the April 3, 1988 rate increase.

The Service's objective to provide service to the taxpayer is primary. To continue this objective, we will be scrutinizing other areas within the Service's budget in an effort to determine possible areas of absorption for both FY 1988 and FY 1989.

Question 3: There has been a steady decline in the percent of tax returns which IRS projects will be audited in recent year budget submissions and the actual audit coverage achieved in those years.

(a) Why is IRS not auditing as many returns as are projected in the annual budget submissions to Congress?

Answer: Beginning with FY 1987, we received an increase in Examination staffing with the onset of the multi-year Revenue Initiative. Although we have overrealized revenue from our initial projections, we have underrealized coverage. The number of examinations in the next few years will not increase as rapidly as initially anticipated for several reasons:

1. Filed returns continue to grow more complex requiring greater time to examine. In addition, our coverage is much greater in the more difficult higher income classes.

2. Our commitment to quality in all our operations means we are taking the time to do things right.

3. Our staffing growth involves revenue agents who audit relatively few returns (compared to tax auditors) but produce high yield.

4. The complexity and administration of the TEFRA laws as they apply to tax shelters results in a steady but slower closure of these cases than we had originally anticipated. We currently have approximately 300,000 TEFRA Tax Shelter returns in the examination stream. These will close, but not as quickly as we had assumed.

(b) Are there too few resources in Examination or is this the first place from which resources are taken to solve problems in other functions?

Answer: Enforcement resources in the FY 1989 budget are consonant with the enforcement revenue assumptions of the Omnibus Budget Reconciliation Act of 1987. Proposed reprogrammings indicated in the budget are intended to properly fund essential tax processing activities without jeopardizing the enforcement targets of the Summit Agreement.

Examination can absorb up to 2,500 new average positions per year. This represents the maximum number of staff that we can recruit, train and deploy in any one year.

(c) What measures do you think can be taken to compensate for the decline in the audit rate?

Answer: It is difficult to compare coverage between years. Given the same number of examinations, an increase in the tax return filings results in a lower coverage level. However, filings have increased, especially in the more complex tax classes where we concentrate our resources. While we are concerned about the drop in coverage over the years, we are more concerned about examining the most non-compliant returns. Our strategy is directed at that goal. Usually the more non-compliant returns are those that are the most time consuming to examine, and this of course results in a lower overall coverage. However, we have continued to increase our information returns program, which we use to detect underreported income and non-filers, to provide a greater presence among taxpayers in general.

4. Under the Administration's FY 1989 budget submission, the Automated Examination System will receive only $1 million in additional funding next year.

(a) What are the benefits of the Automated Examination System and what is the benefit-to-cost ratio?

RESPONSE

The Automated Examination System (AES) will support the tax return examination process. Using automated data processing technology, the system will:

- reduce the time required to conduct audits;
- improve the quality of examinations;
- improve the effectiveness of examination actions as a result of greater timeliness and availability of tax account information;
- provide better workload controls; and
- produce comprehensive management information by integrating fragmented systems.

System life benefits are revenue improvements (additional tax collected), and overhead and systems cost reductions. Benefits also include the Examination portion of Servicewide Citator System. Examination and other staff-years saved as a result of AES implementation will be reapplied to the technical workforce, resulting in significant improvement in revenue collections. Cost reductions will include the elimination of existing systems and cost for postage, printing and travel.

Intangible benefits of the AES include improved voluntary compliance and improved public image of the Service. The erosion of public confidence in the ability of the IRS to effectively enforce tax laws will be lessened through the increase in the number of audits that can be conducted and the quality of the examinations.

The benefit-to-cost ratio now stands at more than 10:1.

(b) Why is the increase requested for FY 1989 so low?

RESPONSE

Due to delays in the Treasury Minicomputer Acquisition Contract (TMAC), and in receipt of the Request for Industry Comment (RFIC), acquisition of hardware, software, and integrator services under the mini/micro phases cannot begin before June 1989 under the current schedule. This is more than a year after the date originally anticipated.

(c) When will all case examiners and tax auditors have desktop computers?

RESPONSE

The TMAC award is now scheduled for July 1989. Implementation of desktop computers for revenue agent groups, tax auditors and tax examiners will begin approximately October 1989 and be completed by July 1992.

(d) When will all revenue agents get direct access to the court cases and research in the citator system?

RESPONSE

Current plans call for all Examination Revenue Agents to have access to the Citator system by the end of FY 1992.

TAX LITIGATION INVENTORY

**5. The estimated inventory of Tax Litigation continues to climb in FY 1989; yet, the Administration's FY 1989 budget submission requested only 2 additional positions.**

Question:

Why are both non-docketed ending inventory for Appeals and the docketed ending inventory for Tax Litigation increasing in FY 1989?

Answer:

The FY 1989 Congressional Budget reflected the following inventory data:

| Ending Inventory | FY 1988 | FY 1989 | Increase |
|---|---|---|---|
| - Non-docketed | 56,154 | 56,348 | 194 |
| - Docketed | 96,484 | 109,234 | 12,750 |
| Total | 152,638 | 165,582 | 12,944 |

As reflected above, the non-docketed inventory was projected to remain fairly stable between the two years. The docketed inventory was projected to increase by 12,750 cases to a total of 109,234 in FY 1989. Closures were expected to underrun receipts by 12,750 for a corresponding increase in ending inventory. The expected increase in docketed case receipts in FY 1989 was based on the expanding Examination workplan in general and more specifically on the expected increase in the number of nonshelter cases relating to the Industry Specialization Program and the Large Case Program. In addition, we projected a relatively small increase in shelter receipts for FY 1989.

Recently, we provided the Committee on Ways and Means and the Committee on Finance with updated figures on current tax court inventories. The FY 1988 Tax Court inventories have decreased below projections made in connection with our FY 1989 Congressional Budget Submission. The decrease reflects both higher than anticipated closures and significantly lower receipts. The FY 1988 decrease in receipts is considered a temporary aberration that will not continue in FY 1989 and beyond.

Question:

How much would the ending inventory levels have improved under the FY 1989 budget which IRS submitted to Treasury requesting 662 additional positions?

Answer:

The 662 additional positions would have added 131 appeals officers and 154 attorneys, along with related paraprofessional and clerical support positions. These positions would have enabled us to close 4820 additional nondocketed cases and 8624 additional docketed cases. The nondocketed inventory would have decreased from 56,348 to 51,528. The docketed inventory would have decreased from 109,234 to 100,610.

EMPLOYEE MORALE AND TURNOVER

**6. What will be the impact on employee morale and turnover if, as projected, the Tax court and refund case receipts increase by 5,000 and there is no increase in the staff level in FY 1989.**

Although the current level of morale could certainly be higher, we do not believe that an increase of 5,000 case receipts without additional staffing in FY 1989 would have an appreciable effect on morale.

A. Question:

What efforts are being made by the IRS to retain qualified professionals?

Answer:

The IRS Office of Chief Counsel has been both aggressive and creative in its attempts to retain its high quality attorneys. For example, the office has increased its award pool by 60% over the 1986 amount and is seeking special salary rates through the Office of Personnel Management for attorneys in those cities where the current federal salary rate is not competitive with private industry. We have increased the number of paralegals six fold over the last three years to enable attorneys to spend more of their time on the largest, most challenging and complex work in the office.

We developed a Visiting Professor Program whereby attorneys are selected to spend a semester teaching at a law school. Increased emphasis on Continuing Management Education (CME) has taken place as well. We also liberalized our leave-without-pay policy to enable employees to obtain higher education or pursue other personal objectives during their careers. The office is attempting to upgrade its space, which is deplorable in some of our district counsel offices. We are also in the process of obtaining automation for our employees, which will, when complete, allow attorneys the ability to do legal research at their desks, as well as eliminate much of the paper that now pervades the office.

B. Question:

Can the IRS continue to compete in the market place for able tax professionals?

Answer:

The IRS is experiencing ever-increasing difficulty in recruiting auditors, Appeals Officers, attorneys and other tax professionals. By way of example, the Office of Chief Counsel can no longer effectively compete for the best and brightest law school graduates because the starting Federal salary of $27,716 is too far below the average starting salary in private, practice. Depending on the studies conducted, the average private salary ranges from $37,000 to $43,000. Although we are doing more intensive recruiting, changing recruiting materials, and utilizing a Summer Intern Program as a way of attracting law students, the pay gap remains a very serious obstacle.

C. Question:

If the current level of attrition for experienced employees continues, what impact will the Administration's proposed FY 1989 staffing level have on the IRS' ability to manage the increasing workload?

Answer:

Our FY 1989 staffing level is adequate in total to manage our workload. Absent a Revenue Initiative that would provide new staffyears to Examination and thus create new work for the Chief Counsel organizations, our FY 1989 staffing level is adequate in total to manage our workload. However, the rate of attrition for our experienced attorneys makes it more difficult to maintain the quality of product we have historically produced, whether it be briefs submitted to the Tax Court, revenue rulings, regulations, or any other work product. As one example of our concern, the rate of attrition that we have experienced has resulted in fewer qualified applicants for managerial positions. Where we once received four or five applications for such positions, we are now looking at only one of two applications for each applicant job. We have recently noticed that, whereas in the past, attorneys were promoted into management positions after 10 to 12 years as a docket attorney, because we are losing experienced positions after only 6 to 8 years of service. Thus our new managers do not have the length and breadth of experience that we have traditionally had.

**7. What is the IRS's position and views with regard to the Administration's FY 1989 budget policy initiative for the privatization of proposing tax dispute arbitration?**

Our study of the privatization proposal will shortly be submitted to and discussed with the Office of Management and Budget. Once that has been done, we will respond to the Subcommittee regarding the proposal.

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

CHIEF COUNSEL

PVT - ref to SW

RECEIVED
JUL 20 1988

JUL 18 1988

The Honorable J. J. Pickle
Chairman
Subcommittee on Oversight
House Ways and Means Committee
Washington, D.C. 20515-6350

Dear Mr. Chairman:

This is in response to question 7 of your April 26 letter to the Commissioner. Question 7 asked what our positions and views were with regard to the proposal regarding privatization of tax dispute resolution. Enclosed is a copy of our study of the feasibility of private tax dispute resolution.

Sincerely,

WILLIAM F. NELSON

Enclosure

## SUMMARY OF FEASIBILITY STUDY OF PRIVATIZATION OF TAX DISPUTE RESOLUTION

As a result of the FY 1989 Office of Management and Budget (OMB) passback, the Treasury Department was required to study the feasibility of developing regulations to permit some categories of federal tax disputes to be resolved through private sector binding arbitration. OMB stated (in Major Policy Initiatives Fiscal Year 1989) that the privatization initiative is to "reduce the Tax Court's backlog and expedite resolution of the taxpayer's claim and the government's receipt of outstanding revenue."

In analyzing whether privatization would achieve these goals, the study examines current tax procedures and their development and the makeup of the current Tax Court docket. It describes typical arbitration procedures and compares them with current Tax Court procedures for various categories of cases to determine whether arbitration would likely foster the stated goals. Based on this analysis, the study concludes that cases in the shelter program and cases eligible for the "S" case procedure are better handled under the current procedures than they would be by arbitration. It finds that cases should receive appeals consideration prior to submission to arbitration. Also, the study concludes, as a policy matter, that private arbitrators should not decide issues of tax law and that any private arbitration procedure should be under the auspices of the Tax Court.

The number of cases that would be potential candidates for an arbitration pool once the above categories of cases are eliminated is significantly less than 3000. Arbitration of this small number of cases would not accomplish in any significant way the goals set by OMB for privatization. It is also important to note that arbitration would impose additional costs on the IRS: staff to develop the new procedures, additional attorneys and support staff to present cases to both the Tax Court and to arbitrators, and arbitration fees. The final conclusion is that OMB's privatization proposal would not fulfill OMB's purpose and would be more expensive than current procedures.

## FEASIBILITY OF PRIVATE SECTOR BINDING ARBITRATION OF TAX DISPUTES

### I. Introduction

As a result of the FY 1989 Office of Management and Budget (OMB) passback, the Treasury Department was required to do a study of the feasibility of developing regulations to permit some categories of federal tax disputes to be resolved through private sector binding arbitration. The purpose of the privatization initiative is "to reduce the Tax Court's backlog and expedite resolution of the taxpayer's claim and the government's receipt of outstanding revenue." 1/

Although OMB's Office of Privatization had no specific proposal for study, some background was obtained at a February 29, 1988, meeting between Treasury and OMB representatives. OMB's Office of Privatization is concerned about the length of time it takes a case to be decided in the Tax Court, about the large number of dockets in the Tax Court inventory, and about the approximately $20 billion in deficiencies and penalties at issue in Tax Court cases. It believes private tax dispute resolution might provide a quicker method, at no additional per case cost to the government, of determining and collecting deficiencies. It envisions a system that would be elective with the taxpayer and would apply to "nonprecedential" sorts of cases that the Service has designated as suitable for arbitration. The cost of the arbitration would either be borne entirely by the taxpayer or by the parties equally. The Office of Privatization wanted the study to propose an arbitration system, address any impediments to such a system, and recommend remedies for any impediments; it would also like the study to address the public policy issues raised by the implementation of a private tax dispute resolution system.

In order to enable comparison of how an arbitration system would work with how the current system works, the first part of the study will describe how tax cases currently proceed through the tax administration system. It will then discuss what statistics indicate about how the process is working and the characteristics of cases that make up the Tax Court docket. Next, the study will briefly discuss arbitration in general and its advantages and disadvantages vis a vis adjudication. After taking a general look at arbitration, the study will analyze the feasibility of arbitration and whether arbitration can achieve

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1/ Executive Office of the President, Office of Management and Budget, Major Policy Initiatives Fiscal Year 1989 at 88.

the results of quicker case disposition and influx of revenue into the treasury with little or no additional cost to the government. Finally, the study will conclude with the IRS's recommendation regarding binding arbitration.

## II. Tax Administration and Procedures 2/

### A. Examination

The trail to the United States Tax Court (Tax Court) begins when a return is selected by the IRS for examination. Examinations may be conducted by correspondence, at an IRS office, or at the taxpayer's home or place of business. At the conclusion of the examination, the examiner may propose an increase in the taxpayer's tax liability. 1/ The examiner's determination is based on the Service's official position, even though that position may, in some instances, differ from the position of the Tax Court or other lower court.

If the taxpayer agrees with the changes proposed by the examiner, he or she signs an agreement form that permits the Service to assess and collect the deficiency. If the taxpayer does not agree with the proposed changes, the Service sends the taxpayer a "30 day letter" which contains a copy of the examination report explaining the proposed adjustments and an agreement form and notifies the taxpayer of his or her right to an administrative appeal of the proposed adjustments. At this point, the taxpayer has three options: to sign the agreement form (which will allow the Service to assess and collect the deficiency), to request an appeals conference, or to do nothing.

If the taxpayer ignores the 30 day letter, a notice of deficiency (also called a "90 day letter") will be sent to the taxpayer. Again, the taxpayer has three options: to sign the

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2/ Appendix A is a diagram of how a case travels from examination to the United States Tax Court.

1/ This paper outlines traditional tax administration as it has applied to taxpayers. However, it should be pointed out that in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Congress altered the procedures somewhat for partnerships and S corporations. Under prior law, all adjustments to partnership and S corporation items were determined and litigated at the partner or shareholder level. For entities qualifying for TEFRA treatment, the new procedures provide for unified partnership or S corporation level proceedings.

agreement form that is enclosed with the notice (which will allow the Service to assess and collect the deficiency), to file a petition within 90 days in the Tax Court (within 150 days if the taxpayer is out of the country at the time the notice is mailed), or to do nothing (which will also allow the Service to assess and collect the tax).

B. Appeals

The Service's appeals system functions as a very successful alternative dispute resolution process. It was created in 1927 to reduce the volume of cases pending before the U.S. Board of Tax Appeals, the predecessor to the U.S. Tax Court. Its primary responsibility is to resolve tax disputes quickly and without trial. 4/

1. Nondocketed Appeals Consideration

As indicated above, upon receiving a 30 day letter, a taxpayer can appeal the findings of the examiner to an appeals office. The appeals offices are independent of the examination function. Appeals conferences are conducted as informally as possible; neither the IRS examiner nor an IRS attorney is present. The taxpayer can represent himself or be represented by an attorney, certified public accountant, or other person enrolled to practice before the Service. The taxpayer is encouraged to bring documentary evidence or witnesses that support his position to the appeals conference. There are no transcripts of the proceedings and no rules of evidence.

The appeals officer will consider the information developed by the examiner and the information and arguments presented by the taxpayer and try to settle the case, taking into account the "hazards of litigation," i.e., whereas the examiner applies Service position to a case whether or not that position will likely prevail in court, the appeals officer tries in the settlement to reflect the Service's chances of winning in court if the case was tried. Therefore, for example, given that in

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4/ Appeals' mission statement reads:

> The Appeals mission is to resolve tax controversies, without litigation, on a basis which is fair and impartial to both the Government and the taxpayer and in a manner that will enhance voluntary compliance and public confidence in the integrity and efficiency of the Service.

most circumstances courts are entitled to approximate a deduction in the absence of written substantiation, 5/ an appeals officer will similarly use an approximation of the deduction as a settlement figure. Appeals officers even have authority to compromise an issue, for example, a dependency exemption, that the Court would be required to find either for the taxpayer or the Service. Appeals officers can also settle a legal issue based on the hazards of litigation. For example, an appeals officer may decide, after some legal research, that the Service has a 60% chance of prevailing on a particular legal issue. The appeals officer is then authorized to enter into a settlement under which the Service concedes 40% of the issue. If the appeals office and the taxpayer agree on the settlement, the taxpayer signs an agreement form and the Service can assess and collect the agreed upon deficiency.

If the taxpayer and the appeals officer are unable to reach a settlement, a notice of deficiency will be issued by the appeals office. As with a notice of deficiency issued after examination, the taxpayer can either sign an agreement form, ignore the notice (in which case the Service is entitled to assess and collect the deficiency), or file a timely petition in the Tax Court.

2. Docketed Appeals Consideration

Taxpayers do not always take advantage of the opportunity to obtain appeals consideration upon receiving their 30 day letter. In these situations, the Service issues a 90 day letter and taxpayers can file a petition in the Tax Court. These taxpayers, who have bypassed appeals, are given an opportunity to settle their case with appeals before trial preparation begins. 6/ As with nondocketed cases, appeals attempts to settle docketed cases by taking into account all the facts presented and considering the hazards of litigation. Generally, appeals retains jurisdiction of docketed cases until it is clear that settlement is unlikely or the case has been scheduled for trial.

C. Tax Court

1. History

The origin of the United States Tax Court is in the Revenue Act of 1924 in which the Board of Tax Appeals, an independent agency in the executive branch, was created out of a need to

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5/ Cohan v. Commissioner, 39 F.2d 540 (2d Cir. 1930).

6/ Rev. Proc. 87-24, 1987-22 I.R.B. 23.

have experts in taxation who were to provide interpretations of the tax laws. 7/ The Board of Tax Appeals was independent of the Treasury Department. In 1942, the name of the Board was changed to the Tax Court of the United States, but the court remained an executive agency. In 1969, the name of the court was changed to the United States Tax Court and it was established as a legislative court under Article I of the Constitution. 8/

Although there are significant distinctions between the Tax Court and other federal courts, Congress made conscious decisions regarding how tax disputes should be resolved when it decided to create a court for this purpose. As noted in The United States Tax Court -- An Historical Analysis:

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7/ "[R]egardless of the detail provided it is impossible to draft an income tax statute which clearly provides for all factual circumstances. Accordingly, in addition to the taxing statute, an income tax system requires a sophisticated administrative body to collect the tax and provide interpretations of the statute." H. Dubroff, The United States Tax Court -- An Historical Analysis 13 (1979).

8/ The Supreme Court in Ex Parte Bakelite Corp., 279 U.S. 438, 451-452 (1929) explained Congress' power to create legislative courts for:

> various matters, arising between the government and others, which from their nature do not require judicial determination and yet are susceptible of it. The mode of determining matters of this class is completely within congressional control. Congress may reserve to itself the power to decide, may delegate that power to executive officers, or may commit it to judicial tribunals.
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> Conspicuous among such matters are claims against the United States. These may arise in many ways and may be for money, lands or other things. They all admit of legislative or executive determination by courts; but no court can have cognizance of them except as Congress makes specific provision therefor. Nor do claimants have any right to sue on them unless Congress consents; and Congress may attach to its consent such conditions as it deems proper even to requiring that the suits be brought in a legislative court specially created to consider them.

> The Coolidge Administration favored informal proceedings as a means of expediting the Board's work, but Congress insisted on the more formal practice of courts. In Congress' view the cohesive body of precedents were [sic] of paramount importance and could only be achieved by a judicial-type body. Undoubtedly, the strictures of formal procedures have slowed the handling of cases, and the problem of backlog has plagued the Board/Tax Court almost from the first. Nevertheless, the tax laws are of such intrinsic complexity that the need for a specialized "court" to resolve disputes and formulate interpretations has never been questioned since 1924. 9/

Congress has limited the jurisdiction of the Tax Court by statute. 10/ The Tax Court has jurisdiction to redetermine the deficiency determined by the Service and to determine the amount of overpayment by the taxpayer. This differentiates the court from other federal courts. As stated by Meade Whitaker, Judge, United States Tax Court:

> The court is not charged with the task of arbitrating or resolving a controversy between a taxpayer and the government over taxes. Rather, the court is directed to determine "the correct amount" of a deficiency or an overpayment. In other words, the court does not simply determine which party wins the lawsuit, but instead determines the taxpayer's correct tax liability. This is a different responsibility, for example, from that of the United States district court in a controversy between two parties. To carry out this responsibility, the court must play a different role in the trial process than would normally be expected of a trial court.
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> For the court to determine the correct tax, all the relevant facts should be put into the record. 11/

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9/ Dubroff, supra note 7, at 162.

10/ See, for example, I.R.C. §§ 6214(a), 6226, 6228, 7428.

11/ Whitaker, Some Thoughts on Current Tax Practice, 7 Virginia Tax Review 421, 437 (1988).

2. Small Tax Case Procedures

Although, as described above, for the most part Congress intentionally chose to inject formality into the tax resolution process, it did provide, in section 7463 12/ a more informal alternative for taxpayers with less than $10,000 at issue for any one tax period. This procedure, called the "S" case procedure, is elected by the taxpayer. Decisions rendered under this procedure are final and cannot be appealed by either the Service or the taxpayer to a higher court. The court has made the procedure more informal by devising a simple form petition that can be filled out by the taxpayer. Also, trial procedures and rules of evidence are relaxed. 13/ "S" cases are generally heard by one of fifteen special trial judges that have been appointed by the Chief Judge pursuant to section 7443A. 14/

3. Pro Se Taxpayers

In the Tax Court taxpayers are permitted to represent themselves 15/ and significant percentages of taxpayers take advantage of the opportunity. 16/

4. Tax Court Procedure

Tax Court cases are initiated by the filing of a petition in the Tax Court by a taxpayer who has received a notice of deficiency. 17/ The Service files an answer (drafted by an attorney) to the petition. 18/ If the taxpayer has previously

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12/ I.R.C. § 7463.

13/ Tax Ct. R. 177(b).

14/ I.R.C. § 7443A.

15/ Tax Ct. R. 24(b).

16/ In FY 1987, 54.5% of all petitions filed were pro se. United States Tax Court Fiscal Year 1987 Annual Report at 4.

17/ I.R.C. § 6213(a); in TEFRA cases, petitions are filed on behalf of a partnership or S corporation that has received a Notice of Final Partnership Administrative Adjustment, I.R.C. § 6226(a).

18/ Tax Ct. R. 36(a).

bypassed appeals, the appeals office attempts to settle the case. 19/ If the appeals office is unable to settle the case, it is returned to counsel for trial preparation. Cases that received appeals consideration prior to petition are normally retained after answer in counsel for trial preparation.

Much of trial preparation in a Tax Court case centers on the creation of a stipulation of facts--a written document signed by both parties in which all agreed upon facts are stated and to which all pertinent documents are appended. Even if there are objections to facts or documents on, for example, grounds of relevance or hearsay, these objections are merely noted in the stipulation and are not a ground for refusing to stipulate. The requirement to stipulate is explicit in the Tax Court Rules. 20/ The court will not enforce pretrial discovery prior to efforts to stipulate. 21/

The Tax Court has only permitted limited discovery since 1974 and discovery against third parties since 1983. 22/ In this way it is significantly different from courts operating under the Federal Rules of Civil Procedure which emphasize discovery. However, although during the examination the Service obtains many critical facts, it is usually necessary for the Service, whether through the stipulation process or formal discovery, to obtain additional facts in the custody or knowledge of the taxpayer or third parties during trial preparation. (Unlike, say, a contract or labor dispute where both parties have much of the relevant information from prior dealings, in a tax case the taxpayer, not the IRS, is the custodian of most of the relevant information). The incompleteness of the fact record may be due to a number of things: the failure or refusal of a taxpayer to provide requested information to an examiner, the failure of the examiner (who is not an attorney) to request needed information, or the failure or refusal of third parties to provide requested information. During this period of fact development, the parties also develop and interview witnesses who may testify regarding facts that the parties are unable to agree upon.

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19/ Rev. Proc. 87-24, 1987-22, I.R.B. 23.

20/ Tax Ct. R. 91(a).

21/ Branerton Corp. v. Commissioner, 61 T.C. 691 (1974).

22/ Dubroff, supra note 7, at 297-305; Whitaker, supra note 11, at 439.

After the facts are obtained, the witnesses prepared, and the stipulation drafted, the case is ready to try. Congress has provided by statute that hearings before the Tax Court shall be open to the public and the testimony shall be stenographically reported. 23/ Because of the stipulation process, trial time is only devoted to those facts upon which the parties cannot agree. After the trial, briefing schedules are set. Taxpayers and the Service (except in "S" cases) file briefs in which they list the facts they believe have been established through the stipulation or through testimony at trial, describe the law as they believe the court should interpret it, and apply that law to the facts of the case. 24/ Tax Court judges consider the entire fact record, the arguments advanced by the parties on brief, and their own legal research, and issue "reports." The reports must include the judge's findings of fact and opinion or memorandum opinion. 25/ Normally the reports are in writing but a judge is permitted to orally state findings of fact and opinion if he is satisfied that the facts and the law are clear. 26/ Oral findings and opinions must be recorded in the transcript and served upon the parties. 27/ The results of the opinions are embodied in decisions, the formal document signed by the Tax Court judge that states what, if any, deficiency exists, and which permits the Service to assess and collect the deficiency. 28/

5. The Calendar Process

The Tax Court is a circuit-riding court. All the judges are based in Washington, D.C., except for one special trial judge located in Los Angeles. They travel to over 75 cities to hear cases that have been placed on one or two-week trial calendars. Large cities may have multiple calendars in a month; small cities may have only one calendar a year.

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23/ I.R.C. § 7458.

24/ Tax Ct. R. 151.

25/ I.R.C. § 7459(b).

26/ Id; Tax Ct. R. 152(a)

27/ I.R.C. § 7459(b); Tax Ct. R. 152(b).

28/ I.R.C. § 6215(a).

There are "small and regular" calendars and "regular" calendars. "Small and regular" calendars, which contain for the most part "S" cases and cases involving less than $10,000, are heard by special trial judges. "Regular" calendars are heard by Tax Court judges. A typical two-week calendar will contain approximately 200 cases. Generally, beginning with its Winter 1987 term, except for tax shelter project cases or cases assigned to a specific judge, the Tax Court has placed its oldest cases on calendars first; i.e., it now uses a first in-first out (FIFO) method of calendaring. During FY 1987 the Tax Court scheduled 115 regular calendars and 152 special trial judge calendars. Additional special calendars were also scheduled for trials that were too time-consuming for the regularly scheduled calendars and for shelter project trials.

The experience of the IRS has been that the calendaring of Tax Court cases acts as an incentive to many taxpayers to settle their cases:

> Many petitioners/taxpayers will not pursue relief within the Service's administrative structure until it is clear they can no longer postpone the determination of the tax liability and that they must incur either the inconvenience of trying their case before the court or the expense of hiring a representative. In many cases, then and only then will they cooperate with the government's representatives sufficiently to allow settlement negotiations to be successful. 29/

The major kinds of cases not put on FIFO calendars are tax shelter cases. To move this inventory, the Service has assigned shelter cases involving common legal and fact issues and which are organized by a single promoter or group of promoters to "projects". A trial of only one case in a project can be dispositive for hundreds or even thousands of similarly situated taxpayers. 30/ There are approximately 365 of these shelter

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29/ Nelson and Keightley, Managing the Tax Court Inventory, 7 Va. Tax Review 451, 464 (1988).

30/ Often, one or more "test cases" on a shelter are selected to go to trial and the parties in the remaining cases involving that shelter file with the Tax Court a stipulation to be bound by the final (i.e., after all appeals are completed) decision in the test case. Approximately 20% of the Tax Court's docket is in this inactive posture; i.e., essentially resolved, but waiting for a final decision in a test case. Statement of Chief Judge Samuel B. Sterrett Before the Subcommittee on Oversight, Committee on Ways and Means, U.S. House of Representatives, April 13, 1988, at 2.

projects containing approximately 36,000 cases. The Tax Court has assigned approximately 240 of these projects to judges. Treating these like cases together is an efficient mechanism for resolving large numbers of cases. It also has enabled the IRS and the Tax Court to treat taxpayers in these shelters consistently.

6. Expedited Tax Court Procedures

The Tax Court has had a procedure available since July 1985 to expedite trial and decision in significant cases. Significant cases are those which affect a large number of taxpayers, involve large dollar amounts, or involve a question of law the resolution of which will make a meaningful contribution to tax law. To have a case assigned to this program, the parties file a Joint Motion for Expedited Consideration. The Chief Judge then assigns the case to a trial judge who sets an early trial date and tries to issue an opinion approximately 6 months after briefs are filed. This procedure has only been used a few times.

7. Nonjudicial Resolution of Tax Court Cases

Over the last few years, under the supervision of the Tax Court, the IRS and taxpayers have agreed in approximately 8 cases to resolve valuation issues through binding expert fact-finding. This procedure reduces the time that must be spent by the court in trying and deciding a case and by the parties in preparing for trial, hiring separate experts, trying the case, and writing briefs. In these cases, once the expert has made fact findings, a Tax Court judge enters a decision based on the findings. Although this procedure has not been used extensively, the Office of Chief Counsel has recently issued a Chief Counsel Notice encouraging its attorneys to use the procedure where possible.

D. Assessments

The IRS is not entitled to assess any tax except as provided in the Internal Revenue Code. 31/ For example, the Service is permitted to assess taxes shown by the taxpayer on his return. 32/

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31/ I.R.C. § 6201.

32/ I.R.C. § 6201(a)(1).

The Service can assess amounts in excess of that shown on the return if the lower amount shown on the return is based on a mathematical or clerical error appearing on the face of the return. 33/ Otherwise, absent special circumstances delineated by statute, the Service cannot assess a deficiency in taxes until after a notice of deficiency has been mailed to the taxpayer, 90 days have passed, and the taxpayer has failed to file a petition in the Tax Court. 34/ The taxpayer can waive in writing the right to a notice of deficiency and thereby permit the Service to assess and collect the amount owing. 35/ If the taxpayer has filed a petition in Tax Court, the Service can assess the deficiency as redetermined by the Tax Court once the Tax Court's decision has become final. 36/ A decision of the Tax Court dismissing the proceeding is considered as its decision that the deficiency is the amount determined by the Secretary. 37/

III. Statistics

A. Nondocketed Cases

A diagram reflecting the numbers of returns moving through the tax system from filing to trial would look something like a pyramid, with the returns filed at the base and the number of cases tried at the apex. In 1987, 150,475,000 income, gift, and estate tax returns were filed. During FY 1987, 1,205,957 income, gift, and estate tax returns were examined. Also in FY 1987, Appeals received 49,443 nondocketed cases 38/ and disposed of 39,688 cases by agreement. Appeals' agreement rate for nondocketed cases was 86.9% in FY 1987.

Approximately 86% of Appeals' income, gift, and estate tax nondocketed nonshelter workload in FY 1987 involved cases with deficiencies of between $300 and $100,000. For this category of case, Appeals spent 1.33 appeals officer staff days per case to

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33/ I.R.C. § 6213(b).

34/ I.R.C. § 6213(a) and (c).

35/ I.R.C. § 6213(d).

36/ I.R.C. § 6215(a).

37/ I.R.C. § 7459(d).

38/ "Case" in the context of the Appeals workload can be a single taxpayer or taxpayers grouped together with common or related issues that may be considered and disposed of together.

dispose of cases between $300 and $6000 and 2.79 appeals officer staff days per case to dispose of cases between $6000 and $100,000. Approximately 88% of Appeals' nondocketed tax shelter workload involved cases with deficiencies of between $300 and $100,000. For this category of case, Appeals expended .85 appeals officer staff days per case to dispose of a case between $300 and $6000 and 1.35 appeals officer staff days per case to dispose of a case between $6000 and $100,000.

B. Docketed Cases

As of March 31, 1988, there were 69,564 cases 39/ pending in the Tax Court. This number is down from a high of 84,007 cases on October 31, 1986, and from the 81,549 cases that were in inventory on September 30, 1987. In FY 1987, the Tax Court closed 45,082 cases 40/ and Chief Judge Sterrett has estimated in a statement for the House Subcommittee on Appropriations for the Treasury, Postal Service and General Government, that in FY 1988 the Tax Court will dispose of 48,000 dockets. 41/ In FY 1987, 42,623 petitions were filed with the Tax Court. 42/

Much of this decrease in inventory and increase in dispositions is attributable to the FIFO calendaring procedure under which the Court has increased both the number of trial calendars and the number of cases assigned to calendars. To illustrate, the number of regular trial calendars increased from 39 during the Spring 1986 term to 52 during the Spring 1988 term. The total number of cases assigned to regular calendars went from 3,910 for the Spring 1986 term to 7,571 for the Spring 1988 term.

The vast majority of the cases filed in the Tax Court are settled without the need for a trial. The Chief Counsel case tracking system shows that in the year beginning on March 1, 1987, and ending on February 29, 1988, Tax Court cases were

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39/ "Case" in the context of the Tax Court represents one petition or docket.

40/ United States Tax Court Fiscal Year 1987 Annual Report.

41/ Statement by Chief Judge Samuel B. Sterrett on the Appropriation Request and Court Program for Fiscal Year 1989, March 3, 1988 at 3.

42/ United States Tax Court Fiscal Year 1987 Annual Report. See Appendix B, Chart A, for further information regarding trends in the Tax Court in receipts, closings and inventory.

disposed of in the following ways: 10.5% were dismissed (e.g., for lack of jurisdiction, failure to properly prosecute, etc.), 67.5% were settled by appeals, 18% were settled by Counsel attorneys, and 4.1% were tried on the merits.

As with nondocketed cases, Appeals settles docketed cases very efficiently. Eighty-nine percent of Appeals' docketed nonshelter inventory involves between $300 and $100,000. For this category of case, appeals officer spent 1.17 days per case to dispose of cases between $300 and $6000 and 2.31 days per case to dispose of cases between $6000 and $100,000. Ninety-two percent of Appeals' docketed shelter inventory involves between $300 and $100,000. For this category of case appeals officers expended .99 days per case to dispose of cases between $300 and $6000 and 1.16 days per case to dispose of cases between $6000 and $100,000.

Other statistical analyses of the Tax Court docket reveal some interesting patterns. Approximately 60% of the Tax Court inventory is comprised of tax shelter cases. Of the nonshelter cases in inventory, 29% are "S" cases; i.e., cases which are already subject to an expedited, informal, binding procedure. The "S" cases move quickly through the Tax Court system; 80% of the "S" cases have been in inventory a year or less. Of the nonshelter cases in inventory, another 24.8% are regular cases with less than $10,000 at issue. Taxpayers in these cases, although eligible for the "S" procedure, elected against the expedited nonappealable route. Sixty-six percent of the nonshelter "active" case inventory is less than one year old, and 82% is less than two years old. 43/

The concentration of deficiency dollars in the largest cases is a dramatic feature of the Tax Court docket. Cases over $1 million comprise only 2.4% of the docket, but contain 81% of the dollars in issue. Cases over $10 million comprise .4% of the docket, but contain 62% of the dollars in issue. 44/ Assuming that arbitration provided a quicker way to dispose of cases than current procedures, it would not significantly accelerate collection of revenue unless the cases involving over $1 million were arbitrated.

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43/ See Appendix B, Chart B.

44/ See Appendix B, Chart C.

IV. Arbitration

"[A]rbitration is a process in which a dispute is submitted to a third party or neutral (or sometimes a panel of three arbitrators) to hear arguments, review evidence and render a decision." 45/ The decision can be either binding or nonbinding. 46/

The arbitration process, like adjudication, involves a number of stages. One commentator has identified six stages: initiation, preparation, prehearing conferences, hearing, decisionmaking, and award. 47/ To initiate arbitration where there has been no previous agreement to arbitrate (such as a dispute resolution clause in a contract), the parties must sign a "submission" that details the procedure to be followed. 48/ The parties must also jointly choose an arbitrator or an arbitrator must be chosen for them. The preparation stage of the arbitration process is similar to preparation for trial. The parties must fully prepare their case, discovery may be necessary, and fact stipulations must be agreed upon. 49/ A prehearing conference may be scheduled in more complex cases to discuss such things as discovery, motions, and hearing dates. 50/ An evidentiary hearing that is not open to the public is normally held. 51/ Transcripts may or may not be taken; if they are, the parties must arrange for them. 52/ At the hearing there may be opening statements or sometimes the arbitrator may require a short written opening and issue statement prior to the hearing. 53/ Evidence and testimony is submitted and the arbitrator rules on such things as the relevancy of evidence. Sometimes regular court rules of evidence apply in arbitration

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45/ Cooley, Arbitration v. Mediation - Explaining the Difference, 69 Judicature 263, 264 (1986).

46/ Id.

47/ Id.

48/ Id. at 265

49/ Id.

50/ Id.

51/ Id.

52/ Id.

53/ Id.

hearings, 54/ sometimes the legal rules of evidence do not apply. 55/ Post-hearing briefs may be required. 56/ The arbitrator's decision may be rendered immediately, or, if the issues are complex or the evidence voluminous, after several weeks. 57/ The "award" or arbitrator's decision is usually written and may or may not be accompanied by written findings of fact and conclusions of law. 58/

There are a number of advantages that arbitration may offer over adjudication. The most emphasized advantage is that arbitration provides a solution for a congested court docket, a quicker way for parties to obtain a hearing of their dispute. 59/ Also, because arbitrator decisions are usually final and binding, they offer speedier finality than

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54/ Rule No. 17(a) of the Rules of Procedure of Judicate, a private court system that arbitrates disputes, provides that "Except as otherwise prescribed by this rule or otherwise agreed to by the parties the Federal Rules of Evidence shall be followed at all hearings before Judicate."

55/ Cooley, supra note 45, at 265.

56/ Id.

57/ Id.

58/ Id.; Judicate Rule of Procedure No. 21(b) provides: "In all matters deemed Complex pursuant to these rules, and in all other circumstances where the parties have agreed, the assigned judge shall find the facts specially and state separately its conclusions of law thereon." Pursuant to Judicate Rule of Procedure No. 8: "A matter will be deemed Complex when it will require substantial judicial intervention or action to resolve issues. Any matter which requires the preparation of findings of fact and conclusions of law will be deemed Complex."

59/ Ad Hoc Panel on Dispute Resolution and Public Policy, National Institute for Dispute Resolution, Paths to Justice: Major Public Policy Issues of Dispute Resolution, 12-13 (1983); Rolph, Introducing Court - Annexed Arbitration: A Policymaker's Guide 6(1984); Hensler, What We Know and Don't Know About Court - Administered Arbitration, 69 Judicature 270, 272 (1986); Nejelski and Zeldin, Court - Annexed Arbitration in the Federal Courts: The Philadelphia Story 42 Md. L. Rev. 787 (1983) Sander, Alternative Methods of Dispute Resolution: An Overview, 37 U. of Fla. L. Rev. 1, 3 (1985); Note, The California Rent-A-Judge Experiment: Constitutional and Policy Considerations of Pay-As-You-Go Courts, 94 Harv. L. Rev. 1592 (1981); Judicate: The National Private Court System 1 (1987).

adjudication. The procedure itself is often more streamlined than adjudication and therefore yields a quicker decision. 60/ Other advantages often cited are that the parties can choose the arbitrator, the proceeding can be kept private, the arbitrator can be required to have expertise in the subject matter, and the resolution can be tailored to the circumstances. 61/

At the same time, there are a number of recognized disadvantages of arbitration vis a vis adjudication. "[T]he efficiency of arbitration sometimes may be achieved at the expense of the 'quality of justice' in an individual decision." 62/ Also, to the extent formality (for example, use of discovery, rules of evidence, and written findings of fact and conclusions of law) is injected into the process, arbitration can develop the type of delay normally associated with adjudication. 63/ If arbitration merely replaces what

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60/ Paths to Justice, supra note 59, at 13.

61/ Id.

62/ Id.

63/ Id; One commentator notes:

> While certainly one of the hallmarks and putative benefits of arbitration is its reduced transactions cost in terms of time and resources, that is not always the case. In some instances the arbitration will look for all the world precisely like a trial with a full complement of discovery, sworn witnesses, briefs, and so on. Even then, the process may still be more expeditious than a court since presumably the hearing can be scheduled more rapidly than a judicial calendar could usually permit. But, before embracing arbitration as a means for resolving a dispute the nature of the arbitration process that is contemplated must also be considered to ensure that the desired benefits will actually materialize (footnote omitted).

Harter, Points on a Continuum: Dispute Resolution Procedures and the Administrative Process (report to the Administrative Conference, June 5, 1986), § 3 reprinted in Sourcebook: Federal Agency Use of Alternative Means of Dispute Resolution 313 (1987).

otherwise would have been a settlement between the parties, it may be a more costly and time-consuming procedure than what would have otherwise occurred. 64/ Some commentators have found that the experience with court-annexed arbitration is that the same percentage of cases tend to be settled and the settlement tends to occur quicker, but the cost of settlement may now increase because it includes the arbitrator's fee. 65/ On the other hand, some analyses suggest that arbitration acts as a settlement inhibitor. 66/ Other potential disadvantages are that arbitration may hide disputes from public scrutiny, may not apply public norms, yields no useful precedent, and lacks uniformity in result. 67/

## V. Feasibility Analysis

### A. Role for Private Arbitration in Tax Dispute Resolution

#### 1. Preliminary Considerations

There are a number of matters that would have to be addressed before an arbitration program could be instituted. First, any arbitration of Tax Court cases would have to take place under the auspices of the Tax Court. The power to lay and collect taxes is a classic governmental function that has been

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64/ Paths to Justice, supra note 59, at 14.

65/ Id. at 18.

66/ One commentator reports:

> It appears from preliminary research that many fewer cases that are submitted to arbitration settle as compared to those that go to trial. Whereas many do settle on the eve of the hearing, perhaps only half as many do so as are settled prior to a trial. This is perhaps surprising, and certainly something that needs to be borne in mind when considering institutionalizing arbitration on a broad scale.

Harter, supra note 63, at 312.

67/ Paths to Justice, supra note 59, at Appendix 1.

delegated to Congress. 68/ As discussed earlier, there is a statutory scheme for the resolution of tax cases in the Tax Court. For example, hearings are required to be open, testimony is required to be transcribed, and opinions are required to be in writing. Furthermore, by statute, once a petition is filed in the Tax Court, the Service may not assess a deficiency against a taxpayer until a Tax Court decision has become final. 69/ We believe this statutory scheme impliedly denies authority for nonsupervised private binding arbitration of tax disputes.

An additional reason that arbitration would have to take place under the auspices of the Tax Court is that the Tax Court is accountable to the public; private arbitrators are not. Court administration of arbitration offers at least some assurance that legal standards have been properly applied. 70/

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68/ U.S. Const. Art. I, § 8, cl. 1; OMB Circular A-76 (Revised) (August 4, 1983) defines "governmental function" as follows:

> "A Governmental function is a function which is so intimately related to the public interest as to mandate performance by Government employees....Governmental functions normally fall into two categories: (1) The act of governing....Examples include criminal investigations, prosecutions and other judicial functions....(2) Monetary transactions and entitlements, such as tax collection and revenue disbursements...."

Circular A-76 also provides that governmental functions shall be performed by government employees.

69/ I.R.C. § 6213(a).

70/ As stated by Senator Hatch:

> In resolving disputes between individual parties, the neutral third party must not render decisions that conflict with or have the effect of making public policy. Public issues should be decided by public officials, who in turn are responsible to the public. It is important to preserve the role of institutions that have been entrusted with the task of promulgating public policy because these institutions are ultimately responsible to the public for the manner in which they discharge their particular duties or functions.

O. Hatch, A View From Congress, Admin. L.J. 427, 431 (1987).

Second, even arbitration under auspices of the Tax Court presents a number of legal issues that would require, at a minimum, coordination with Congress and probably the enactment of legislation before an arbitration program could be initiated. If the IRS and taxpayers paid the costs of arbitration absent congressional authority, such payment could be considered an unauthorized and improper augmentation of the Tax Court's appropriated funds in light of the fact that the Tax Court is specifically charged with responsibility for adjudicating tax controversies between the Commissioner and taxpayers and has specifically received funds for that purpose. 71/ From the IRS point of view, expenditure of funds for arbitration would also constitute a reprogramming of funds since existing appropriations do not anticipate support of a program of this nature. Typically, reprogramming requires that an agency notify the appropriation committees in Congress to ensure that there is adequate notice that funds appropriated for one purpose are being used for another. Finally, if the Tax Court does not implement arbitration on its own, some congressional action would be required to mandate the establishment of such a program. 72/

Third, this study presumes favorable policy decisions by tax administrators on questions regarding the wisdom and propriety of private arbitration that are separate and apart from the questions regarding which categories of cases are susceptible to arbitration. 73/ These policy decisions would have to be faced before arbitration could be implemented.

2. How Arbitration Might Work

Arbitration could be implemented on either an individual case basis or under specially designed Tax Court procedures. If done on an individual case basis, parties that elect to submit

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71/ 31 U.S.C. §§ 3301, 1301, 1535.

72/ Public comments by the Tax Court on the OMB proposal have been cautious: "I do, however, have certain reservations about the appropriateness and productiveness of arbitration procedures for tax cases. From a very fundamental perspective, I must question whether the Federal government should delegate to private entities the resolution of Federal tax matters." Statement of Samuel B. Sterrett, Chief Judge, United States Tax Court, Before the Subcommittee on Oversight, Committee on Ways and Means, April 13, 1988, at 3. If the Court would not afford parties the time to go to arbitration or enter the arbitrator's decision, any arbitration procedure would be pointless.

73/ See, for example, note 72, supra.

their case to arbitration could file with the Tax Court a joint motion for permission to submit the case to arbitration and a stipulation containing the procedures to be followed. The stipulation would contain such things as an agreement that the arbitrator's decision would be final, the method for choosing the arbitrator, the rules of evidence to be followed, the timing of the various arbitration procedures, whether testimony would be under oath, whether a record of the hearing would be made, how fees would be split, how subpoenas would be enforced, etc. If the motion were granted, the court might issue an order for arbitration that sets deadlines and requirements for the arbitrator and for the parties.

If Tax Court procedures were promulgated permitting arbitration, they would address the matters suggested above and the motion filed by the parties could be limited to such matters as a statement of the issues to be arbitrated and any permissible deviations from or additions to the normal arbitration procedures.

B. Types of Cases Potentially Susceptible to Arbitration

The Office of Privatization has asked us to consider what categories of cases in the Tax Court docket might be susceptible to arbitration. We have concluded that the following are potentially arbitrable: docketed, nonshelter regular cases that are not eligible for the "S" election and that have received appeals consideration. We have eliminated cases that have not received appeals consideration and cases eligible for the "S" procedure from the arbitration pool because there is no reason to radically change these long established systems that are working well. Disposition of these cases by arbitration would not be appreciably quicker and in some instances would be significantly slower than current procedures. Arbitration, with the attendant arbitration fees and the costs for extra IRS attorneys to handle this second "docket" of cases, 74/ would also be more expensive than current procedures. In addition, we have concluded for policy reasons that legal issues in cases

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74/ Although arbitration theoretically would remove some cases from the docket of Tax Court judges, it does not relieve the docket of the IRS attorneys who represent the government in every Tax Court case. Additional attorneys and support staff would need to be hired in order for the IRS to continue carrying the Tax Court docket while simultaneously carrying an arbitration docket. The number of additional attorneys required would be determined by the number of potential arbitrators and arbitrations.

should not be arbitrated. Our specific rationales for eliminating cases not fitting the above description from the arbitration pool are detailed below.

1. Taxpayers should attempt to settle their cases with Appeals prior to submitting them to arbitration. 75/ As described above, Appeals settles 67.5% of the docketed Tax Court cases in a very efficient manner (2.3 appeals officer staff days per nonshelter docketed appeals case between $6000 and $100,000). Arbitration, on the other hand, would require time-consuming trial preparation-like activities by attorneys and thus would take longer than appeals consideration and would be more costly. Replacing appeals consideration with arbitration would be a step toward formality, the opposite of what arbitration tries to achieve. 76/ Furthermore, permitting taxpayers with docketed Tax Court cases access to arbitration as an alternative to appeals might have an adverse effect on their high nondocketed appeals settlement rate, thus swelling, rather than decreasing, the Tax Court docket.

2. Current procedures should be retained for shelter cases. Precedent and the project concept are the keys to efficient handling of this portion of the Tax Court docket. Arbitration might require multiple presentations of the same case before arbitrators and, even if group arbitration were possible, would achieve nonprecedential and nonuniform results.

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75/ Of course, even now, although IRS procedures encourage taxpayers in docketed cases that have not had nondocketed appeals consideration to negotiate in a bona fide manner with Appeals, the IRS has no mechanism to force taxpayers to do so. The same situation would exist with respect to arbitration.

76/ In reaching a conclusion that practical considerations militated against use of alternative dispute resolution (ADR) techniques in Federal Tort Claims Act claims at the agency level, one commentator noted: "First, ADR's principle attraction is its potential for avoiding long and costly judicialized proceedings. But the tort claims process at the agency level is highly informal and wholly subject to the agency's control. ADR would be a step toward, not away from, formalization." R. Berg, Legal and Structural Obstacles to the Use of Alternative Dispute Resolution For Claims For and Against the Federal Government 23 (January 1988) (Unpublished Report for the Administrative Conference of the United States).

3. Cases eligible for the "S" procedure should not be arbitrated. Taxpayers in these cases already have available to them an informal, expedited, binding procedure -- thus, arbitration does not offer an advantage for these cases. In addition, current "S" procedures have a significant advantage over arbitration in that these cases are heard by the special trial judges, i.e., tax specialists. Also, arbitration would add a significant cost to the parties that they do not now bear: arbitration fees. 77/

4. Legal issues in cases should not be arbitrated. Litigation of cases containing legal issues, including mixed questions of law and fact, creates important precedent and guidance for all taxpayers; arbitration does not. There is, therefore, a hidden cost to the public in allowing arbitration of legal issues: the continual relitigation of the same questions of law. In addition, arbitration would inevitably create a confusing second body of tax law (even if that body of law was called "nonprecedential").

Even staunch proponents of alternate dispute resolution, such as the National Institute for Dispute Resolution and the Administrative Conference of the United States recognize that, where legal norms are unclear, adjudication is the preferred method of dispute resolution. 78/ In its Recommendation 87-5, "Assuring the Fairness and Acceptability of Arbitration in Federal Programs," 79/ the Administrative Conference stated that, "Cases subject to arbitration should involve questions of fact or the application of well-established norms, even if statutory, rather than precedential issues or application of fundamental legal norms that are evolving."

In weighing the value of precedent (which is advanced by adjudication) against the value of speed (which arbitration may offer), with respect to legal tax issues, we have decided that precedent is the more important value. Therefore, we have concluded that legal issues should not be arbitrated.

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77/ See note 81, infra.

78/ "[Courts] are the appropriate forum when the purpose is to establish a societal norm or legal precedent. Thus, for example, if the underlying cause of a dispute is not how to apply an accepted norm but rather a need to create such a principle, then courts--or the legislature--are the appropriate forum." Paths to Justice, supra note 59, at 10.; see also ACUS Recommendation 86-3, "Agencies' Use of Alternative Means of Dispute Resolution," 1 CFR § 305.86-3.

79/ 1 CFR § 305.87-5.

5. There are significantly less than 3000 Tax Court cases that are potential candidates for arbitration. Starting from the March 31, 1988 inventory of 69,564 Tax Court cases, assuming that the rate of cases settled by Appeals and dismissed by the Tax Court remains constant, once shelter cases and cases eligible for the "S" procedure are removed from the pool, there are 2854 cases left. (See Appendix C) We do not know how many of these cases contain legal issues, but it is reasonable to conclude that a significant number of them do; therefore, there are significantly less than 3000 cases in the Tax Court docket that are candidates for arbitration.

VI. Conclusion

This study has examined the potential offered by arbitration to achieve three goals: speeding the length of time it takes a case to be decided in the Tax Court, reducing the Tax Court docket, and accelerating the collection of deficiencies. Arbitration would provide a theoretically quicker and more efficient resolution for only a small segment of the Tax Court docket. Arbitration of the cases identified as suceptible to arbitration will not significantly impact revenue because the dollars at issue in the Tax Court are heavily concentrated in a relatively few large cases that generally contain legal issues. Similarly, the arbitration of less than 3000 cases will have little impact on the size of the docket.

We believe that the Tax Court is properly managing its inventory and is processing cases in an expeditious manner. The Tax Court has reduced its inventory from 81,549 cases at the end of last fiscal year to 69,564 on March 31, 1988. Even though some of that reduction is attributable to TEFRA partnership petitions and some increase can be anticipated as we enter the "filing season," the Tax Court's disposals have increased. We think the Tax Court is addressing the various categories of cases in the docket in an appropriate manner and we will continue to work with the tax bar and the Tax Court to improve and expedite the handling of Tax Court cases. 80/

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80/ For example, we have just distributed a Chief Counsel Notice to our attorneys encouraging them to utilize the expert fact-finding procedure where appropriate.

Arbitration would add costs to tax administration: arbitration fees, 81/ the salaries of the extra IRS attorneys and support staff that would be required to present arbitration cases and the costs that both the IRS and the Tax Court would incur to set up and maintain procedures.

In summary, we have found that arbitration will not impact any of the three goals of the initiative in a significant way.

81/ Arbitration costs vary, of course, but they are usually significant. For commercial arbitrations, the American Arbitration Association, a not-for-profit organization, charges an administrative fee ranging from $300 for cases involving claims of less than $25,000 up to about $60,000 for claims of $50,000,000 or more. There may also be additional fees for arbitrators. AAA Commercial Arbitration Rules 18 (as amended January 1, 1988). Judicate, a private court system that has talked with OMB representatives about tax dispute resolution, has said it would charge a $75 administrative fee, $750 for a hearing of a day or less, and, if additional time to write findings of fact and conclusions of law were required, an additional $750. To the extent arbitrator time was required for discovery or additional hearing days, there would be additional fees. Telephone conversation between Sara Coe, IRS, and Alan Epstein, President, Judicate, Inc., April 6, 1988. As of 1981, a "rent-a-judge" in California was paid $500 a day during trial plus $100 per hour for time spent on the case after trial. Note, The California Rent-A-Judge Experiment: Constitutional and Policy Considerations of Pay-As-You-Go Courts, 94 Harv. L. Rev. 1592, 1598 (1981).

APPENDIX A

Income Tax Appeal Procedure
Internal Revenue Service
At any stage of procedure
You can agree and arrange to pay
You can ask the Service to issue you a notice of deficiency so you can file a petition with the Tax Court
You can pay the tax and file a claim for a refund
Examination of income tax return
Preliminary notice 30-Day Letter
Protest (when required)
Appeals Office
If you do not respond or the 30-day period expires, then
Notice of Deficiency 90 Day Letter
CHOICE OF ACTION
Pay tax and file claim for refund
Petition to Tax Court
Tax Court
No appeal permitted in cases handled under small tax cases procedure
Agreed
Appeals Office
Unagreed
Reconsidered by appeals because of settlement possibility
District Counsel
Trial
U.S. Supreme Court
Court of Appeals

NOTE: REFUND PROCEDURES, WHICH ARE NOT COVERED BY THE PRIVATIZATION PROPOSAL, HAVE BEEN DELETED FROM THIS CHART.

APPENDIX B--STATISTICAL CHARTS ON THE TAX COURT INVENTORY

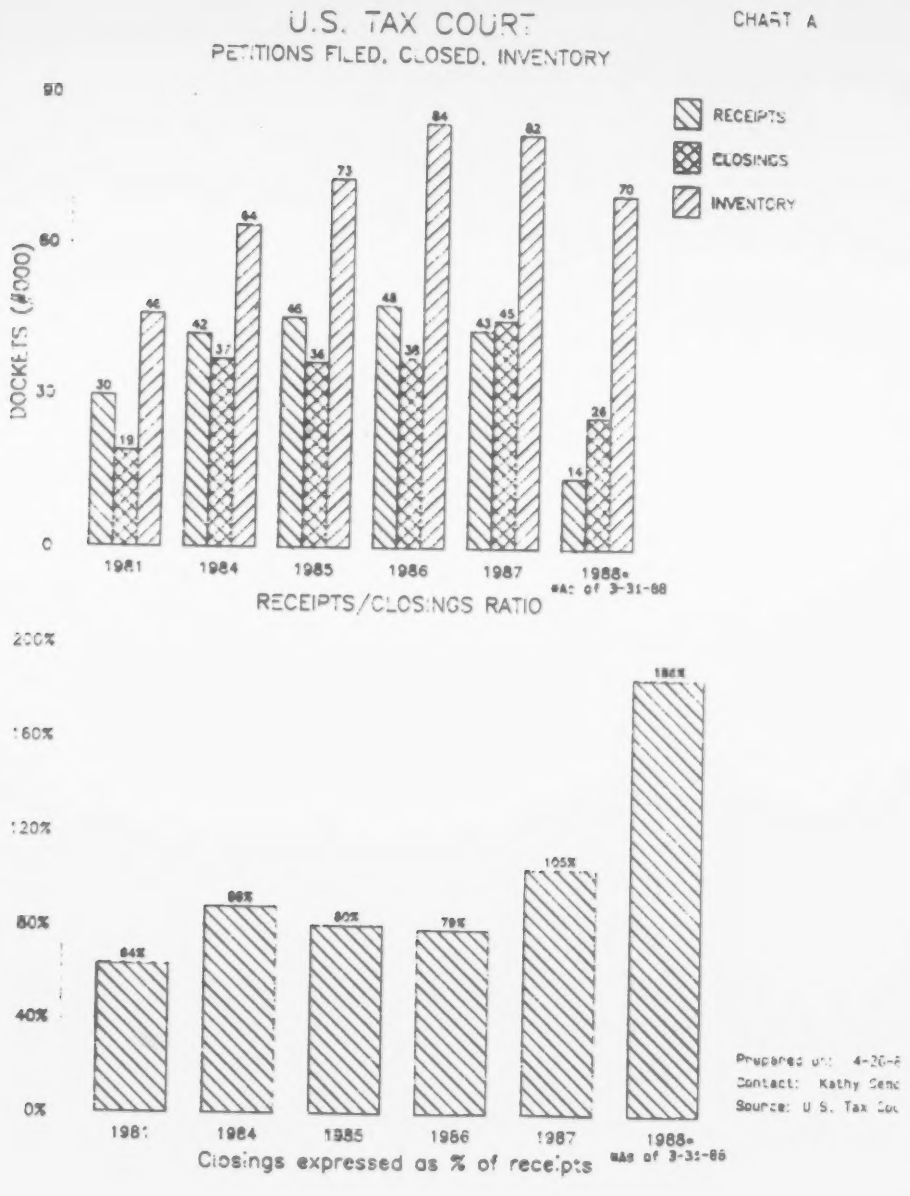
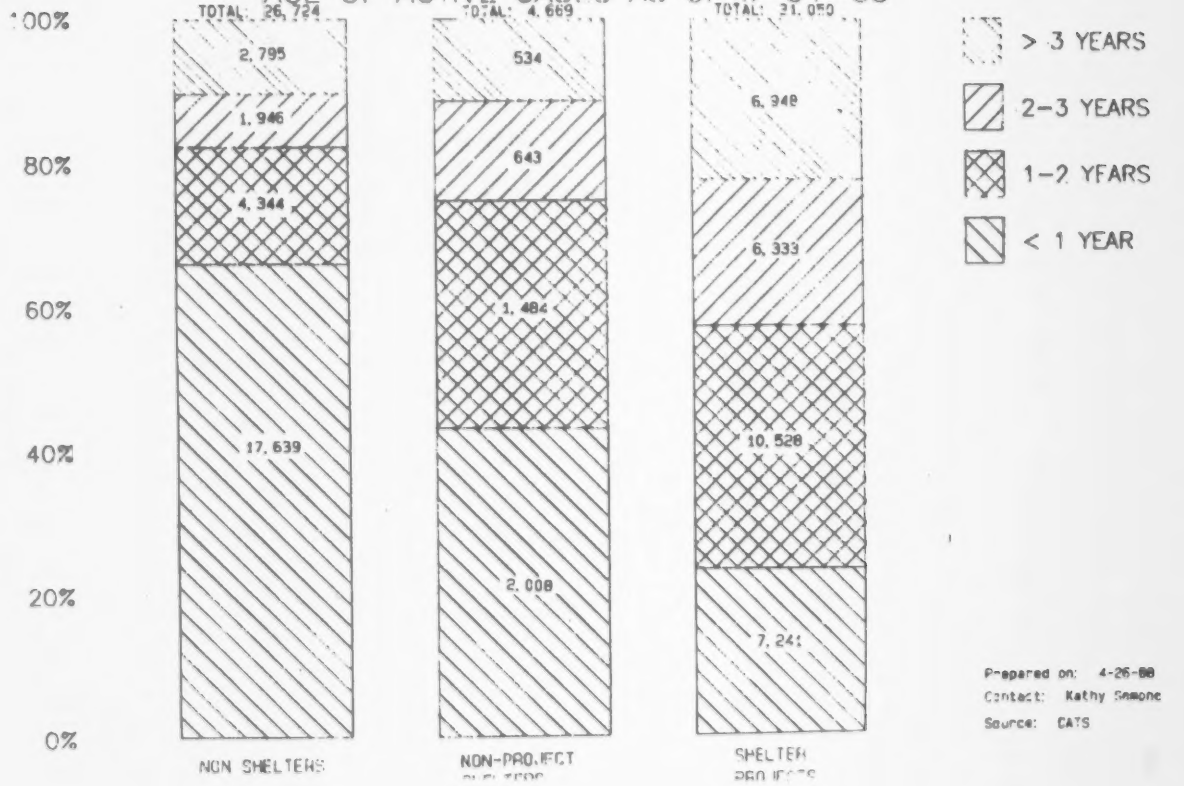


CHART B

# U.S. TAX COURT INVENTORY

## AGE OF ACTIVE CASES AS OF 3-31-88

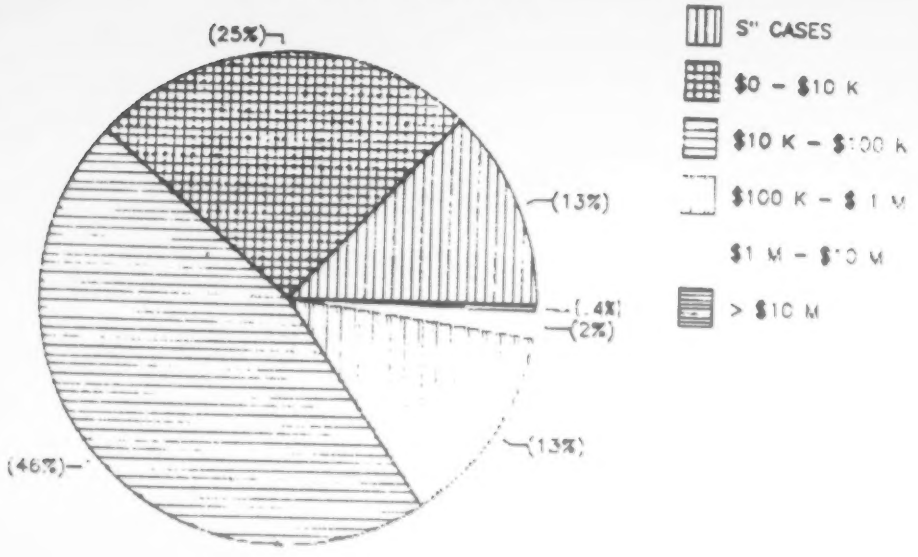



Prepared on: 4-26-88
Contact: Kathy Simone
Source: CATS

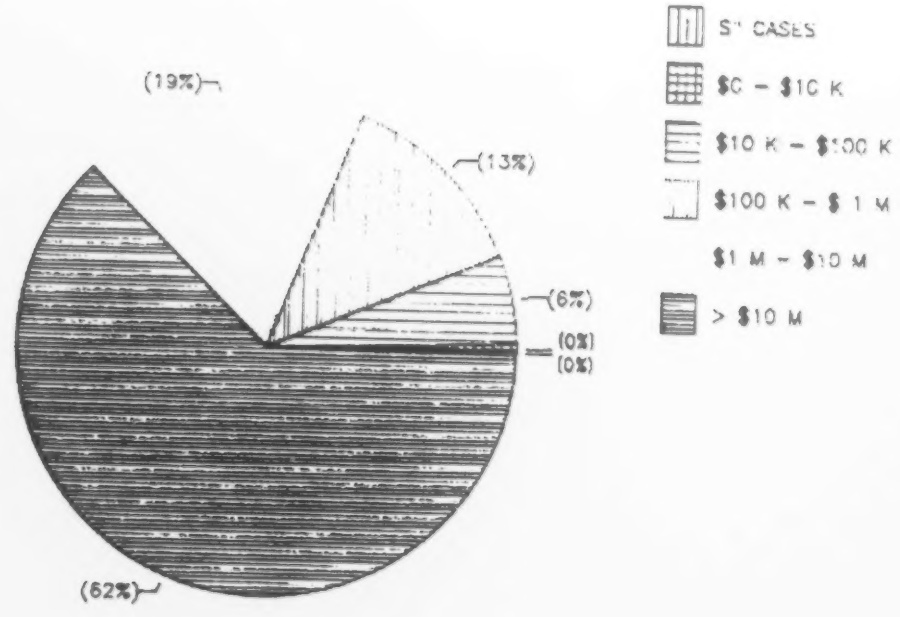
# TOTAL TAX COURT INVENTORY

AS OF 3-31-88

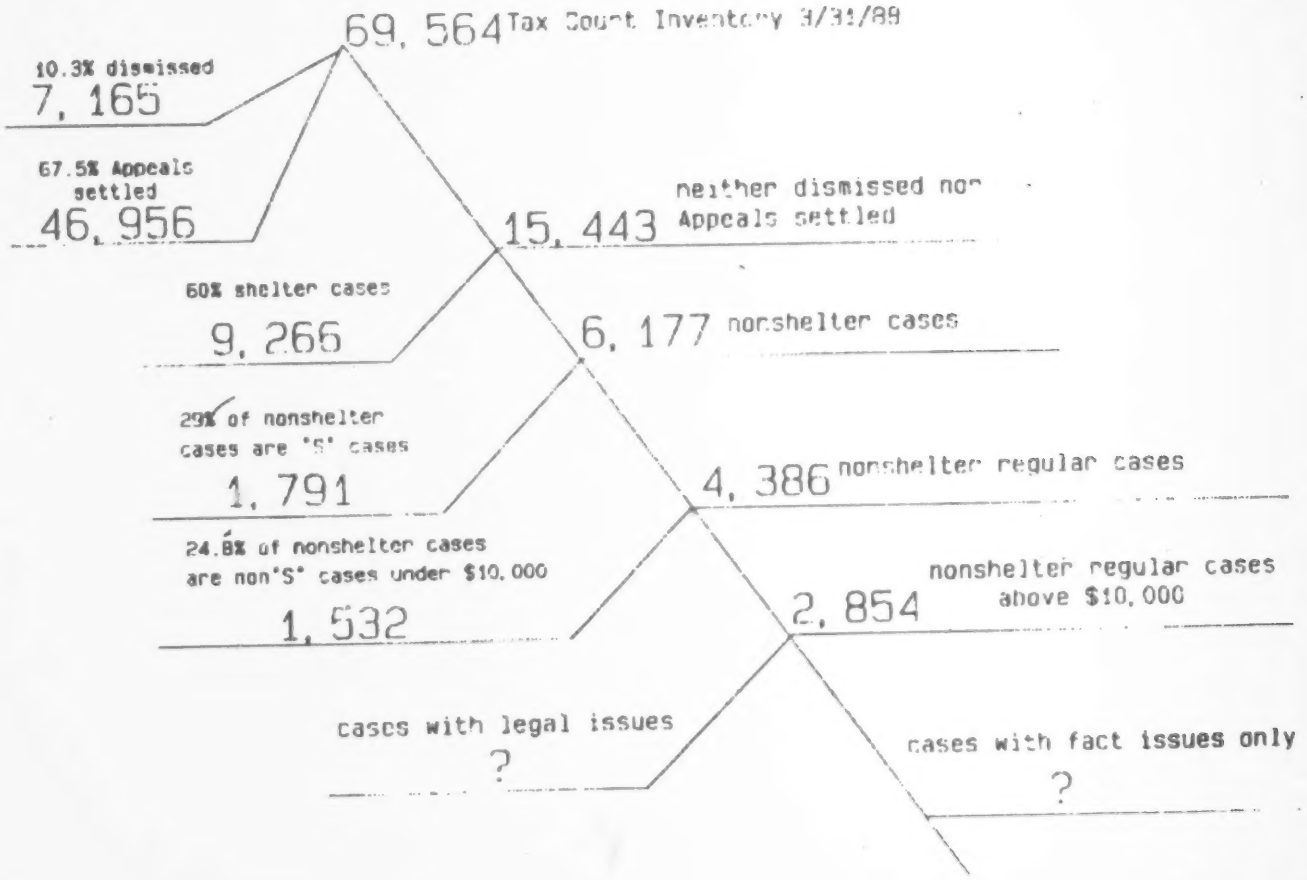
CHART C




DOCKETS




TAX + PENALTY


69, 564 Tax Court Inventory 3/31/89
10.3% dismissed
7, 165
67.5% Appeals settled
46, 956
neither dismissed nor Appeals settled
15, 443
60% shelter cases
9, 266
6, 177 nonshelter cases
29% of nonshelter cases are 'S' cases
1, 791
4, 386 nonshelter regular cases
24.8% of nonshelter cases are non'S' cases under $10, 000
1, 532
nonshelter regular cases above $10, 000
2, 854
cases with legal issues
?
cases with fact issues only
?

## EMPLOYEE PLAN DETERMINATION LETTERS

Question 8: The IRS expects the number of employee plan determination letters to increase by 50 percent in FY 1989. How can a one percent increase in the staff handle the increased workload?

Answer : The employee plans determination workload will increase dramatically between FY 1988 and FY 1989, because plans will wait until the 1989 deadline to submit their amendments to comply with the highly complex provisions of the Tax Reform Act of 1986 (TRA).

In addition to the small FY 1989 staffing increase, we received larger staffing increases in an FY 1987 supplemental appropriation and in FY 1988. Our hiring had to be accomplished early in order that the new employees could develop a sufficient level of expertise to be able to review the very complex issues contained in the heavy volume of amendments.

## CRIMINAL INVESTIGATION

Question 9: Under the Administration's FY 1989 budget submission, how many additional agents will be committed to money laundering investigations?

Answer: In FY 1989, Criminal Investigation will devote 53 additional special agents to investigate the growing number of investigations relating to money laundering operations and narcotics activities.

ACCOUNTS RECEIVABLE INVENTORY

Question: 10(a) At the Subcommittee's FY 1988 budget hearings last year, you indicated that the IRS would be completing its study of the accounts receivable inventory this Spring. When will your findings be complete? Based on your findings to date, what is your estimate of the portion of the accounts receivable inventory which is uncollectable?

Answer: Price-Waterhouse was awarded the contract to study the growth and composition of our accounts receivable inventory. The study has been completed and we are expecting the final report within the next several weeks. After we have reviewed the findings of this report we expect to design and implement a new accounting system changes as we will be re-classifing and defining existing collection accounts to give us more meaningful accounting data on which to measure our accounts receivable.

After we are able to review the final report, define what should be considered as an account receivable and for what period of time it is deemed collectable we would be pleased to share with you what we have learned and what the make-up of the accounts receivable will be.

Question 10(b) What resources in the Administration's FY 1989 budget submission will be devoted to reducing the accounts receivable inventory? To what extent will collection activities in FY 1989 reduce the accounts receivable inventory?

Answer For FY 1989 we have allocated 15,358 collection staff years to accounts receivable. Revenue yield continues to be a key factor in determining work priorities. Our Resources and Workload Management System (RWMS) will give priority to accounts with greater potential yield. Under this system, the amount of revenue collected will increase even though the number of cases in inventory may increase.

Question 10(c) How much money is being lost annually due to expiration of the statute of limitations? How many delinquent accounts are represented in this revenue loss?

Answer: In FY 1987 the statute of limitations for collection expired on 610,900 delinquent accounts with revenue totaling 1.3 billion dollars. Of this amount, however, only $42 million in collectible revenue was lost. The balance had been placed in not collectible status based on prior investigative work by our Collection Personnel, or was deemed as not workable because it was below Collection tolerances.

PAYMENT BY CREDIT CARD

Question 11(a) Has the IRS discussed the components of the two-year pilot program suggested at the end of February 1988 by OMB? If so, please explain the program.

Answer: After enabling legislation is secured the Service has preliminary plans to pilot the acceptance of credit cards in two regions. Our discussions with OMB have concerned the submission of a legislative proposal to amend IRC section 6311 to enable the Secretary to accept credit card tax payments.

The Service does envision that the pilot will encompass payments received in district offices and service centers. Credit card payments can be received with returns, taxpayer notices and many other forms of correspondence. A taxpayer will also have the ability to walk in to an IRS office and provide payment through this method.

During this pilot period extensive monitoring and evaluations will be performed in order to determine the benefits to the Treasury. If after the evaluation of the pilot, the determination is made to go nationwide with the acceptance of this payment method, all IRS correspondence and returns will refer to credit cards as one more option the public may elect to pay Federal taxes.

Question: 11(b) What are the advantages and disadvantages of such a program? What is IRS's views and position with regard to such a program?

Answer: Payment of Federal taxes by credit card offers advantages to both the taxpayer and the Service. These advantages include convenience for the taxpayer and improved customer service, another payment option for the taxpayer, reduced IRS contact for many taxpayers, improved processing and reduced paper handling for the Service, improved compliance, and improved cash flow for Treasury.

At this point the only disadvantage is in the resources needed for the Service to implement this program. The Service will not pursue payment by credit card unless it is cost beneficial.

The Service is strongly committed to securing legislation that will allow tax payment by credit card. We believe all commercially acceptable methods of payment should be permitted for Federal tax payment. There are clear benefits for both the public and government.

Question: 11(c) If necessary legislation was adopted, how long would it take for the IRS to implement this program? What would be the cost to the federal government?

Answer: Once legislation is passed, the acceptance of this payment method will be evaluated before any consideration is given to nationwide implementation. From the point the legislation is adopted, the Service will need a lead-time of 18 months to establish a pilot program. We estimate a pilot program of one year in duration and, based on acceptance, it should take a minimum of 6 months to phase-in the remaining offices nationwide. We want to ensure that any processing problems or unexpected difficulties are fully resolved before a program is implemented nationwide.

The estimated cost to the federal government will be $4.3 million. This represents additional equipment, in-house processing, and authorization credit card transactions costs.

Question: 11(d) What has been the outcome of IRS discussions with credit card companies?

Answer: Credit card companies and financial institutions have been supportive of the proposed legislation. However, since a bill has not been formally introduced in Congress, discussions to date have been limited to learning about the details of the credit card network and operations, and how best to incorporate IRS's needs into the system.

Question 12: IRS's FY 1989 budget submission to Treasury requested 463 more positions for Taxpayer Service than OMB included in the Administration's FY 1989 budget submission. What services could have been provided under IRS's proposal which will not be provided under the Administration's FY 1989 budget submission?

Answer: The additional 463 full-time equivalent positions requested in the Treasury budget submission were designed to increase the quality of the Taxpayer Service tax assistance effort.

Due to changes in the complexity of the workload and due to increased emphasis on effective communications techniques, the amount of time our toll-free assistors spend on each call has increased. Part of the Treasury budget request was to account for lower productivity rates while maintaining the same level of service.

Another area that Taxpayer Service attempted to address in the Treasury budget submission was the need to increase the experience level of new employees. The traditional staffing cycle for Taxpayer Service is to recruit new seasonal employees in the late summer, train them in the early fall and place them on furlough until needed in the winter, at the beginning of the filing season. The two or more months lapse between training and their first on-the-job experience results in loss of skills in newly trained assistors and employees finding other jobs. Thus, the employment lapse is partly responsible for poor quality responses on the toll-free telephone assistance line. The Treasury budget submission would have allowed newly-hired seasonal employees to remain on-board, in pay status, from the time of their graduation from training to the filing season. It is felt that keeping these employees on-board would allow them to put their newly acquired knowledge to work immediately and would allow them to start developing the communication skills necessary in dealing with the public.

Question 13: IRS' FY 1989 budget submission to Treasury requested $4.8 million for the Automated Taxpayer Service System. Only $2 million was included in the Administration's FY 1989 budget submission. What will not be done under the Administration's budget request which IRS would like to do in FY 1989?

Answer: The $2,905,000 difference was associated with site preparation costs of $2,251,000 and Taxpayer Service Training costs of $654,000. $183,000 remains in the budget for site preparation. Funds for site preparation and furniture that were not included in the budget would have allowed the expansion of this system to our other offices. The budget would allow us to begin that expansion to the few sites where site preparation costs are minimal.

Question 14: The administration's FY 1989 budget submission increases the number of positions in Returns Processing and Computer Services; however, IRS's FY 1989 budget submission to Treasury requested an increase which was three times larger.

(a) What will be the impact of the administration's failure to approve IRS's requested level of resources?

(b) Why did IRS request 3,700 more employees for FY 1989 than were authorized in FY 1988?

Answer: The reduction you noted reflects a slowing in the rate of systems modernization. The Administration did not cut our current budget. During the past eleven months, projects have been refined and, in many cases, preliminary implementation dates have been found not feasible because of technological or procurement delays.

The reduction of 3,700 average positions principally reflects the following adjustments:

-- resources to support Examination revenue initiative denied;

-- deferred adverse tax consequences and alternative strategies for tax administration (DATC/ASTA) projects denied;

-- re-computation of full-time equivalency (FTE) to overtime (1500 positions);

-- various ADP modernization efforts denied;

-- A-76 program review savings.

TAXPAYER CORRESPONDENCE

Question 15: GAO reported to the Subcommittee that there are serious problems with the quality of IRS's handling of taxpayer correspondence. What resources in the Administration's FY 1989 budget submission will be used to improve the quality of correspondence at the Service Centers? What additional resources are necessary to improve the quality of correspondence which are not provided in the Administration's budget request?

Answer: We have taken several steps to improve the quality of our taxpayer correspondence. These initiatives include revised formal training, increased on-the-job training and a review of the ratio of technical employees to managers. In addition we developed a Program Analysis System to assist the centers in monitoring their accuracy and enabling them to analyze trends to determine where additional training is needed. We estimate that an additional 202 staff years would be necessary to improve the accuracy/quality of the Adjustments/Correspondence program.

QUESTION 16
ACCURACY OF RESPONSES TO TELEPHONE INQUIRIES

Question: The subcommittee continues to be concerned about the accuracy of IRS's responses to both telephone inquiries and correspondence.

(a) How are production standards and/or quotas used by the IRS to measure employee performance in those areas?

(b) What consideration is being given to the impact of performance standards which emphasize quantity, and not quality, on the accuracy of IRS's responses to telephone inquiries and correspondence?

Answer: (a) Taxpayer Service does not use production standards and/or quotas to measure employee performance in answering telephone inquiries and correspondence. The Service does establish level of service expectations for its toll-free telephone program. However, our field offices are provided resources to staff their sites with the number of employees needed to meet this goal. An Adjustment/Correspondence tax examiner's rate of production is used as a measure of his/her performance in comparison to the production rate of all other tax examiners who are doing the same type of work at the same grade level and in the same service center. Employees who are not performing, at the rate of predetermined by management to be minimally successful, are counseled about the deficiency and if their production does not improve to a satisfactory level they are subsequently: given additional training, reprimanded, or discharged depending on past performance. In addition, a low production rating on a performance evaluation could jeopardize an employee's promotion potential.

(b) Quality is a major area of emphasis for Taxpayer Service employees. Assistors are provided training and on-the-job instruction designed to help them probe sufficiently to determine the taxpayer's questions and to answer it completely and accurately. Accuracy is closely monitored during the year and feedback provided to employees and additional training is provided as necessary.

The Adjustment/Correspondence Branch, through a recently developed Program Analysis System (PAS) and Adjustments Receipts and Timeliness Study (ARTS), has recognized that an emphasis on the quantity of cases closed, rather than on thoroughly and completely resolving the

case, could be the cause of many of the multiple contacts that are received from taxpayers. Many new, revised, and expanded procedures that emphasize quality have been incorporated into the handbooks. As quality is emphasized, we expect quantity rates to decrease. However, this decrease should be offset by fewer multiple taxpayer contacts.

ERROR RESOLUTION INVENTORY

Question 17: Is the IRS seeing more taxpayer errors or returns processing errors in the error resolution inventory during the 1988 filing season, in comparison to the 1987 filing season? What percentage of the error resolution inventory is comprised of returns processing errors?

Answer: The number of taxpayer errors has increased and the number of service center errors has decreased in the Error Resolution System (ERS) inventory over the last year. The service center errors represent 42.9% of the ERS inventory.

Percentages are:

| | 1987 | 1988 |
|---|---|---|
| % of returns in ERS inventory due to taxpayer error = | 42.3 | 45.9 |
| % of returns in ERS inventory due to SC error = | 46.7 | 42.9 |
| % of returns in ERS inventory due to consistency checks = | 11.0 | 11.2 |

(An example of a consistency check on the ERS inventory is the IRA deductions field; this field is displayed for the examiner to analyze, rather than being displayed for an error condition).

It is important to note, that our ERS system, in addition to identifying specific errors and preventing incorrect case work, provides focused quality assessments for our use in improving our overall work products.

BULK MAILINGS OF TAX FORMS TO PRACTITIONERS

Question 18: The Subcommittee was recently contacted by an accounting firm and informed that the IRS has significantly limited the number of tax forms given to tax practitioners. The firm specifically referred to bulk order requests for employer payroll tax quarterly forms (Form 941).

(a) What is the IRS's policy, and reason for such policy, with regard to bulk orders for tax forms?

Answer: The IRS no longer provides bulk quantities of tax forms to tax practitioners, although the Service does continue to provide them with information copies of tax forms and a variety of other publications. The decision to cease providing forms in bulk quantities was carefully considered over a long period of time and followed extensive discussions with representatives from the practitioner industry.

Prior to the 1986 filing season, IRS supplied tax practitioners with unlimited quantities of any tax form they requested. A user charge of $1 per 100 form units was applied to each order. Because Title 44 of the U.S. Code allows only the Superintendent of Documents at the Government Printing Office to sell printed materials, the $1 user charge only covered our handling and shipping costs. IRS spent approximately $6 million per year on this bulk forms program and, although about $2 million was recovered through the user charge, that money was deposited in the General Fund, not an IRS operating account. Our net expenditure was the initial outlay of $6 million, which prompted us, in 1985, to begin exploring ways to reduce costs for this program. In 1986 we instituted the current procedures.

Question: (b) Does the IRS limit the number of forms supplied to tax practitioners? If so, why?

Answer: The IRS decided to set a maximum limit on the number of forms that may be obtained by a practitioner, principally in order to reduce agency expenditures. It also became apparent to us that, in providing free forms in bulk, we were effectively subsidizing the practitioners' operations. We were providing a product, free of charge, that would otherwise have to be purchased from GPO or private sector printing firms.

While we have reduced the number of tax forms printed at agency expense, we have not limited the practitioners' ability to obtain either forms or necessary information. Practitioner firms are still able to obtain up to, but no more than, 15 information copies of most tax forms. They are also able to obtain up to two copies of any instruction or taxpayer information publication (500 and 900 series publications). IRS continues to provide one copy of items such as Package X and Publications 17 and 334. Reproducible proof copies (repros) of tax forms and instructions continue to be available from IRS at a cost of $1 per page. Additionally, the Superintendent of Documents at GPO sells bulk quantities of most tax forms.

Chairman PICKLE. Now the Chair would ask the Honorable Samuel Sterrett, Chief Judge of the U.S. Tax Court, if he would come forward.

Judge Sterrett, we have your statement, and your entire statement will be included in the record. If you care to summarize, that would be satisfactory.

The Chair would observe that we are mindful that you may be entering into private practice here after all these years of public service. You have done a very commendable job in the Tax Court. We will be sorry to see you go, but we know that you have earned it. We assume that at some point you will be again appearing before the committee later.

**STATEMENT OF HON. SAMUEL B. STERRETT, CHIEF JUDGE, U.S. TAX COURT, ACCOMPANIED BY HON. LAPSLEY WALKER HAMBLEN, JR., JUDGE, AND CHARLES S. CASAZZA, CLERK OF THE COURT**

Judge STERRETT. I hope so. I appreciate your comments, Mr. Chairman. There was a lot of trauma associated with my decision, and I intend to stay active in the tax section and hopefully make some small contribution to the system.

Thank you for making my statement part of the record. At the outset, let me say, Judge Hamblen, the chairman of our Court's legislative committee is on my right, and Charles Casazza, the Clerk of the Court, is with me on the left. And in the interest of time, I will simply read the summary of statement.

Our inventory as of March 31, 1988, was 69,564 cases pending before the Tax Court, which represented a decline of 14.7 percent since September 30, 1987. Filings for the first months of fiscal 1988 were 25.3 percent lower than during the first 6 months of fiscal 1987. The Tax Court closed 25,732 cases between October 1987 and March 1988, a 20.6 percent increase over the same period a year ago. The Court is proud of that figure. The statistics thus show considerable progress in reducing but not eliminating, of course, our inventory.

With respect to our budget for fiscal 1989, we have requested an appropriation of $29.345 million, an increase of only 2.3 percent over fiscal year 1988, not including the cost of a special building improvement project. The Court has requested authority for 350 positions for fiscal 1989, the same level as 1988. Within the last year, the Court has hired several senior attorneys to assist with complex cases.

I might interject here that the Court is grateful for your intercession with respect to the number of positions that we could have and which led directly to our hiring more senior attorneys.

If the Court's budget request is approved, the Court's resources will be sufficient to achieve its objective of even further reducing its inventory.

With respect to the arbitration proposals, the Tax Court is more than willing to review and participate in developing alternative dispute resolution procedures that would be effective in reducing the Court's inventory. However, the Court questions whether it is

appropriate to delegate the resolution of Federal tax disputes to private entities.

Further, the Court believes that any arbitration proposal should be studied prior to implementation in order to determine whether it will have a measurable effect on the Tax Court's inventory and whether its benefits will exceed its costs.

Obviously, Mr. Chairman, I will be happy to answer any questions the committee may have.

[The statement of Judge Samuel B. Sterrett follows:]

STATEMENT OF SAMUEL B. STERRETT, CHIEF JUDGE, U.S. TAX COURT

Mr. Chairman and members of the Subcommittee, I appreciate the opportunity to appear before you today to discuss the progress the Tax Court is making in managing its caseload and the Court's fiscal year 1989 appropriation request. As requested by Chairman Pickle, I will also address the proposal put forward by the Administration that alternative dispute resolution procedures be used to resolve certain matters pending before the Tax Court.

Tax Court Inventory of Cases Is Decreasing

Last April, when I appeared before the Subcommittee, questions were raised about the steady increase in the number of cases pending before the Court, accentuated by a record high inventory of over 84,000 cases on October 31, 1986. As I indicated during last year's hearing, the number of petitions filed with the Court increased 292% in the period between fiscal year 1977 and the beginning of fiscal year 1987. The Court's considerable efforts to bring down its inventory were being frustrated by the huge volume of incoming cases, including over 48,000 filings in fiscal year 1986 alone.

This year, however, I am pleased to report to the Subcommittee encouraging news about the Court's workload. In short, the pending inventory at the end of fiscal year 1987 was, for the first time in the Court's history, lower than the total at the end of the previous year. Let me assure you that this progress does not suggest that the Court's efforts last year were greater than in prior years, but it does indicate that the Court's case management tools are effective and are having a salutary impact on the inventory. Certainly Congress deserves a large measure of credit for the decline in case filings which is in part attributable to the enactment of interest and penalty provisions applicable to tax shelter activities as well as to statutory changes relating to partnership actions. Similarly, the Internal Revenue Service should be properly recognized for its contributions, particularly the more flexible settlement policy it is pursuing.

As I testified last April, 83,686 cases were pending on September 30, 1986. One year later that number had fallen to 81,549, a modest but important decrease of 2.6 percent. As a sign of even further and more substantial progress, the total number of cases pending as of March 31, 1988, was 69,564, a decrease of 14.7 percent since September 30, 1987, and 16.9 percent since September 30, 1986. While the Court has still to face what has normally been its busiest filing season of the year, the statistics are heartening. We have now witnessed 18 months of progress in controlling the volume of cases before the Court and we hope to see that trend continue.

Mr. Chairman, I readily acknowledge that the number of pending matters before the Tax Court is still too high, and I assure you that the Court is not relaxing its efforts to further reduce the inventory. Nevertheless, we believe that we are moving in the right direction. Our past initiatives and present actions will produce, we hope, even further improvements by the end of the current fiscal year. Last April, I told this Subcommittee that the Court expected to close over 40,000 cases in fiscal year 1987. In fact, we closed 45,082 cases. The goal for the current fiscal year is 48,000 closings. If we reach our objective, it will be a significant achievement for the Court and for the tax system overall.

Thus far, the indications are that we will attain our goal. There were 25.3 percent fewer filings in the first six months of fiscal year 1988 than during the same period in fiscal year 1987. In addition, closings in the last six months -- a total of 25,732 -- represent an increase of 20.6 percent over the first half of fiscal year 1987 -- a number of which the Court can be proud. I

reiterate that over 69,000 pending cases are still too many. Yet even that total, when properly analyzed, reveals that the volume of disputes is really much lower than the bare number reflects.

Approximately twenty percent of the total number of cases on the Tax Court's docket are "sitting on the sidelines," so to speak. The reason is that in the tax shelter area particularly, several so-called "test cases" are frequently selected from a group of up to 2000 cases. Many times the parties in the remaining cases file with the Tax Court an agreement to be bound by the final decision in the test case. Those cases cannot be closed by the Court until the matter is resolved by the United States Court of Appeals (or Supreme Court) before which the case is pending, even though the matter has been decided by the Tax Court. Additionally, there are a number of cases in which the parties have agreed to settle their disputes based on this Court's opinion, the losing party having decided not to appeal.

Accordingly, a significant portion of our current cases will be closed once there is a final resolution of the test cases. When you consider this, together with the marked decrease in filings, the work before the Court is quite clearly becoming more manageable.

## Tax Court Appropriation Request For Fiscal Year 1989

Addressing next the issue of funding and resources, the Tax Court's appropriation request for fiscal year 1989 is $29,345,000. When you exclude from this amount a major new building improvement project, that is, a chiller system for the Tax Court building, the 1989 request is only 2.3 percent higher than the Court's funding for fiscal year 1988.

The Court has not asked Congress for any new positions for fiscal 1989. You will recall that during last year's hearing on the Tax Court, Chairman Pickle inquired whether the Court needed more personnel than the 339 positions requested for 1988. I indicated that if the Court were given 11 additional positions, it would use some of those to hire experienced attorneys to assist our judges and law clerks with complex disputes and thus contribute to our goal of closing more cases. We also pledged to use some of the positions to hire clerical and support personnel. Following the hearing, a letter was sent from the Subcommittee on Oversight to the Chairman of the Treasury, Postal Service and General Government Subcommittee of the House Appropriations Committee requesting, among other things, that the Tax Court be authorized 350 positions for fiscal year 1988. Those additional positions were approved by Congress in the appropriation for the current fiscal year. We are grateful for the kind assistance and support given by Chairman Pickle and the members of this Subcommittee.

The Court has, during the last year, hired three senior attorneys. These lawyers all have experience in the field of tax and are providing valuable assistance to our judges and staff. Some of the other new positions have been allocated to support and clerical jobs in the offices of the Clerk of the Court. Although new filings have fallen, there is still a tremendous amount of paper requiring processing.

I have tried to describe the character of the Court's inventory and to indicate that the number of pending cases is not as overwhelming as the statistics might suggest. In addition to reducing the mere number of cases, the Court is also continuing to take steps to bring cases to trial in a timely manner, and promptly to issue its decisions.

Prior to last year's hearing, the Court submitted to the Subcommittee a report on a variety of case management techniques being utilized by the Court. Among the procedures discussed was the Court's "FIFO" method of scheduling cases, a system begun in January 1987. I am happy to report that under that procedure, which assures the scheduling cases in the order of filing, cases are being called for trial in all cities within twelve months of the date the case is commenced. In a number of cities, such as Atlanta, Boston, Denver, Phoenix and Washington, D.C., cases are scheduled for trial only six months after the petition is filed. When you add to that equation the fact that trial notices are sent five months before the calendar call in order to provide parties sufficient preparation time, it is fair to say that the Court is acting on its inventory in a very expeditious manner. By providing a prompt trial, we are showing taxpayers and the government that the Court is concerned about its work and that the judicial system can provide a speedy and fair review of tax disputes.

Similarly, the Court is concerned with issuing its opinions in a prompt manner. In small tax cases -- those involving $10,000 or less in dispute per taxable year -- a decision is issued, on average, 6.7 months after the trial. In regular cases, opinions are issued, on average, 14.1 months after the case is tried. This average includes at least four months for the filing of briefs after the trial is completed. We hope to reduce that time-frame, but there are still a number of shelter cases and other complex matters in our inventory requiring careful consideration by the Court. And, as noted above, the decision in a single shelter case can dispose of several hundred or more dockets. Thus, the time spent on such a case, will produce significant results.

## Proposal For Use of Arbitration To Resolve Tax Court Cases

Lastly, I would like to respond to the Subcommittee's question as to whether there is a need for, or it is advisable to use, binding arbitration as an alternative method of case resolution. As I am sure you are aware, the President's Fiscal Year 1989 Budget proposes the development of a private mediating institution to reduce the number of cases pending before the Tax Court. The President's Budget states that "the Administration proposes to study the feasibility of developing regulations to permit taxpayers with certain disputes filed in the U.S. Tax Court to use private, alternative dispute resolution firms." The decision by the private firm would be binding on both parties.

I should note that the Tax Court was not consulted about this proposal prior to its inclusion in the Administration's Budget. The information contained in the President's budget documents gives a broad outline of the proposal for a mediation procedure but provides few details as to how the new process would function. Accordingly, it is difficult fully to address the initiative.

I do, however, have certain reservations about the appropriateness and productiveness of arbitration procedures for tax cases. From a very fundamental perspective, I must question whether the Federal government should delegate to private entities the resolution of Federal tax matters. The judicial review of tax cases seems to me to be an essentially governmental function. Secondly, I would assume that any cases involving important legal issues would continue to be resolved by the courts. I would argue that it is only appropriate for legal issues to be decided by judicial officers. However, if that is the expectation, then perhaps the proposal will not be particularly effective because it is the larger, more complex cases that take longer to resolve and demand more of the Court's resources.

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Certainly the Court is willing to study the feasibility of some alternative methods of resolving certain types of cases. The Court has already planned to study whether special masters could be used for fact-specific cases, for example, a matter involving a deduction for a charitable contribution of artwork where the only issue is the value of the painting that was donated. Alternative dispute procedures for those types of cases would allow our judges and special trial judges to spend their time on more complex cases, cases involving legal issues. However, there are not a great many purely factual cases suitable for arbitration procedures pending in the Court. Thus, to view the arbitration proposal as an effective method for substantially reducing the pending caseload is not realistic.

Further, I would caution that the proposal for a mediation institution needs further analysis. In particular, there should be a determination as to whether arbitration would be cost-effective -- that is, would the expense of establishing and maintaining the program outweigh its benefits? Furthermore, it needs to be determined whether alternative dispute resolution procedures would in fact produce a more prompt result than what is already occurring in the Tax Court's small tax case process.

In sum, while the Court is not opposed to the concept of arbitration, we believe that any such proposal should be studied before it is implemented. We welcome suggestions that would lead to the expeditious and fair resolution of matters before the Court, but we strongly believe that the Court should participate in the development and supervision of whatever alternative dispute resolution procedures are implemented.

## CONCLUSION

In conclusion, I am pleased to be able to state today that there is encouraging news about the progress the Tax Court is making in reducing the Court's inventory. Our judges, special trial judges and staff are committed to further achievements in that regard. As I reported last year, the Court has been using a variety of procedures to better manage its inventory. We have now seen the fruits of those efforts. The decline in new petitions has also contributed to the reduction in the Court's inventory; Congress and the Internal Revenue Service should be given appropriate credit for that.

I believe that the staffing and funding levels of the Tax Court are adequate at this time, assuming we do not face a significant reduction in our fiscal year 1989 request. The Court's goal is to continue to use its resources in the most productive way possible. I am confident that will happen.

Thank you for the opportunity to testify here today.

Chairman PICKLE. Judge, you said you had a decline of 14.7 percent since September of 1987.

Judge STERRETT. Yes, sir.

Chairman PICKLE. What has brought about the decline? How did you reduce that figure?

Judge STERRETT. The reduction is really attributable, one, to fewer petitions being filed, which in turn is attributable to several factors: One, the additional legislation Congress gave us in the partnership area; the increased penalties that the Court has been authorized to impose for frivolous returns; and the fact that the Service, in its audit procedure, apparently has been more flexible, therefore leading to fewer notices of deficiency and, therefore, fewer petitions; and, hopefully, we have had some management techniques that have been of some help.

The other side of the coin is that we have increased the closings of cases; that is, we simply have brought more cases to final decision, either through urging settlement or through our decisions in the tax shelter area, which have succeeded in resolving hundreds of cases at one crack.

Chairman PICKLE. Now, you are requesting 350 positions for this next year's budget. That is the same level that you had last year. You are not asking for any extra people.

Judge STERRETT. No, sir, we are not. We believe that the diminishing inventory demonstrates that we are able to handle the situation with our current list of employees.

Now, that does not mean, obviously, that the situation may not change. There has been some talk, I have heard, this morning about the tax laws changing. Not that they should not be changed.

Our projection of 350 employees does not contemplate any changes in the tax code.

Chairman PICKLE. Now, your statement to us indicates that 20 percent of the docketed Court cases are "sitting on the sidelines", waiting for final resolution of so-called test cases.

If you had a resolution in a test case, how many cases would that apply to in various categories of the test cases?

Let me give you an example. Suppose we had test cases in five different areas, five different types of test cases. Would that automatically cut your load down in half, we will say?

Judge STERRETT. It would cut it down considerably. For example, we had a decision involving a commodity straddle in which we decided, mostly for the Government, but that is irrelevant. That decision was just affirmed by the ninth circuit. There is something like 2,000 cases pending in our Court that will now be disposed of. They may apply for certiorari but they will never get it. So we will probably close out those 2,000 cases.

In short, you postulated 5 test cases. It is conceivable that it could run 8,000 to 10,000 cases that could be disposed of by 5 test cases.

Chairman PICKLE. What is holding it up? Are test cases sought before your Court? Are you singling out that which is a test case? Do you make that determination?

Judge STERRETT. We urge the parties to pick a test case. We try to get the Government and the taxpayers' attorneys to pick a test

case in a given tax shelter that we can try. If they will not do it, we will pick it for them. But we want a test case.

Chairman PICKLE. How many test cases do you have pending now?

Judge STERRETT. About seven or eight in various promotions. It has been a very effective measure for resolving large groups of cases.

Chairman PICKLE. Well, I can see why a test case would wrap up a lot of cases. You could thin your numbers down.

Now, as a layman, it has always disturbed me to know that you have got 70,000. At one time we had over, I think, 100,000.

Judge STERRETT. No. We got up to 85,000, though.

Chairman PICKLE. Oh, 85,000. That sounds like an astronomical figure to me.

Judge STERRETT. Yes, it does.

Chairman PICKLE. I think the average American citizen would say, if you have got 85,000 or 70,000 cases that are under litigation and have not been settled, they just kind of suck in and say, my gosh, we never will get a resolution to these questions.

Is 70,000 an average figure? Is that normal? It is not normal on what happened in years past, but should we expect that many cases all the time pending?

Judge STERRETT. Under existing circumstances, we would expect that figure to continue to drop. I am hopeful that by the end of this fiscal year we will be down to, say, 65,000. Of course, if I am wrong, the next chief judge can explain it. But, anyway, that is our best guess.

Chairman PICKLE. Well, I have a feeling that we do not have to have that large a number if test cases is one way to improve it.

Now, 2 years ago, I think, when we had you before this committee, you did not want any other personnel. You did not think you needed any more positions. We did give you 350. So you are saying now with that extra we do not need any more? You can handle the situation?

Judge STERRETT. Well, I say, again, under existing circumstances that is so. I think you have to realize while the number of cases sounds enormous, we are now in a position where virtually every case, where the parties want it, will go to trial within a year from the date the petition is filed. And I daresay there are not many courts in this country that can make that statement. We will get you to trial within a year if the parties want it. And if the parties will file their briefs promptly, we will get a decision to them within another year.

So we think that we are processing the cases in a fashion that is acceptable.

Chairman PICKLE. All right. Now, one last thing. I have noted from your statement that you look with considerable doubt about the advocacy of the privatization of these suits, and you are saying that you have questions about it, and that we ought to proceed very cautiously before we enter into a Federal dispute settlement of this approach.

Judge STERRETT. I do, indeed.

Chairman PICKLE. Well, I appreciate your view.

Now, Mr. Schulze?

Mr. SCHULZE. Thank you, Mr. Chairman.

Thank you, Judge, for your testimony. In one of your statements, you said that the ability to impose additional fines for frivolous or groundless actions has been of assistance. Would you expound on that a little bit more for me?

Judge STERRETT. Yes. Congress enacted a provision denoted section 6673 which permits us to impose a penalty of up to $5,000 for the filing of a petition in which it is alleged that the income tax laws are unconstitutional, et cetera; just frivolous grounds where clearly the man is simply trying to throw sand in the gears. It is not a forthright claim.

We have imposed penalties on those, and I think the word is getting around among the tax protester movement that we will not put up with that any more. That has been very effective.

But I did not testify 2 weeks ago before this committee with respect to penalties, and by my statement today, I do not mean to say that the penalties in general cannot be improved, that there is not a jumble there. Because they can be.

Mr. SCHULZE. What I was getting at is that what you seem to be saying is that this has been a positive deterrent to both cut your caseload and to reduce the frivolous actions.

Judge STERRETT. Yes.

Mr. SCHULZE. I believe that that is very good.

Judge STERRETT. Yes. We appreciate the Congressman's comment.

Mr. SCHULZE. I think you are doing very well, that you are heading in the right direction, and I just hope that under future leadership the court can continue along those lines. Thank you, Judge.

Thank you, Mr. Chairman.

Chairman PICKLE. Mr. Dorgan?

Mr. DORGAN. Thank you, Mr. Chairman.

Just one brief question. I understand your testimony about test cases and the cases that are sitting on the sidelines awaiting the results of those test cases. The increase in enforcement that is occurring and will occur at the Internal Revenue Service will almost certainly result at some point in additional cases. The increase in enforcement is the genesis for, I assume, increased workloads in your area.

How do you estimate that?

Judge STERRETT. Well, we have no control over how many statutory notices of deficiency IRS sends out. There is no doubt that there is a relationship between the number of notices of deficiency and the number of petitions. That is an imponderable element over which we have no control.

I believe the figure, although I can check it, that one petition is filed for about every five 90-day letters. Is that right, Mr. Casazza?

We got those figures from the chief counsel's office, but I think it is about one out of five. So if they send out another 100,000 statutory notices, we will get more petitions. There is no question about that.

Mr. DORGAN. When your partnership decision is rendered, will there be an increase or decrease in the number of docketed cases, in your estimation?

Judge STERRETT. Well, the partnership provisions, which have pretty much put the tax shelters out of business, have been a tremendous help. Because in the past if a tax shelter involved 2,000 investors, we would get 2,000 petitions. Now, under TEFRA, we will get one petition from the tax matters partner. It has made a tremendous difference in reducing the number of petitions that have been filed. It has been a big help.

Mr. DORGAN. When the partnership decision is rendered, is there not a potential for each partner being challenged by the Service with respect to the impact of the partnership decision on certain individual tax items?

Judge STERRETT. Not with respect to the partnership items. No, sir. We can resolve in one case the tax dispute arising out of the partnership items. Now, there may be other items on the taxpayer's return that may remain in issue, but not the partnership items.

Mr. DORGAN. All right. Well, I guess I was asking about the individual tax items.

Judge STERRETT. It would not resolve those, no, sir. It would have no bearing on whether or not the man gave $100 to charity or something like that.

Mr. DORGAN. But when the partnership decision is reached, will there not then flow from that the potential of the IRS challenging on individual items that would result in an increase in your caseload?

Judge STERRETT. Well, it is just a question of judgment. In my judgment, it would not have any relationship.

Mr. DORGAN. No further questions.

Chairman PICKLE. Judge, I thank you for your testimony. Let me ask you one general question.

Referring to recent times, we have given the Tax Court the authority to impose these fines of up to $5,000 for frivolous action or where the parties fail to get together. Have you used this in many instances? Have you used it at all?

Judge STERRETT. Yes, we have used it frequently. We think it has had a meaningful effect on the number of frivolous petitions being filed.

Chairman PICKLE. I would think that the possibility of fine would get my attention. You think it has speeded up your cases?

Judge STERRETT. Oh, indeed, yes.

Chairman PICKLE. Well, is the fact that your dockets have declined 14 percent, is part of that attributable to the fact that you have that fine?

Judge STERRETT. Yes, it is, indeed. It is, indeed, in part attributable.

Chairman PICKLE. So you have used it, not extensively but whenever needed or justified?

Judge STERRETT. Whenever needed, we have used it. And the circuit courts have never disagreed with our use of it. So, apparently, we are doing it all right.

Chairman PICKLE. Well, let me ask you this further question: Who will be the judge when you retire?

Judge STERRETT. The new chief judge we elected last Friday is a man by the name of Arthur Nims.

Chairman PICKLE. Judge Hamblen, will you still be there?

Judge HAMBLEN. Yes, sir. I will be here, and I expect I will remain as chairman of this committee. I hope so.

Chairman PICKLE. Well, we will be visiting. We enjoyed our visit with you last year, and we will try to be back again this year.

Judge Sterrett , we wish you well. You have rendered our Republic great service. Thank you.

Judge STERRETT. Thank you, Mr. Chairman. I certainly appreciate your many courtesies.

Chairman PICKLE. Now, we will ask our friend from GAO, Mr. Finch, if he will come forward and take the position at the witness table.

Now, Commissioner Gibbs, I understand you must go, but you are going to leave somebody here. I want somebody to hear the testimony of the GAO.

Mr. GIBBS. Yes, our Deputy Commissioner of Operations and also our Assistant Commissioner of Taxpayer Services.

Chairman PICKLE. Thank you very much.

Next is the statement of Johnny C. Finch, representing the General Accounting Office. Mr. Finch, we are glad you are here. Your entire statement will be made a part of the record. Would you like to summarize?

**STATEMENT OF JOHNNY C. FINCH, DEPUTY DIRECTOR, GENERAL GOVERNMENT DIVISION, U.S. GENERAL ACCOUNTING OFFICE, ACCOMPANIED BY DAVID J. ATTIANESE AND LARRY H. ENDY, GROUP DIRECTORS**

Mr. FINCH. Yes, I would, sir. We have provided you and the members a copy of the summary statement that I am going to read from, if you would like to follow along, sir. The detail will be submitted.

With me at the table, incidentally, sir, to my right is Dave Attianese. Dave is the group director who was responsible for much of the budget analysis work that was done. To my left is Larry Endy, who was responsible for most of the work that was done in the area of taxpayer assistance.

We are pleased to be here today to assist the subcommittee in its inquiry into IRS's budget request for fiscal year 1989 and the status of the 1988 filing season. My first comments will be directed at IRS's budget.

IRS's proposed budget for fiscal year 1989 totals $5.3 billion and provides for 113,811 average positions, an increase of $240.8 million and 1,650 positions over the authorized levels for fiscal year 1988. This increase is small compared to the increases for fiscal years 1987 and 1988. Perhaps the most notable feature of the 1989 budget is the absence of any initiative to increase tax revenues.

Several initiatives were included in Treasury's submission to the Office of Management and Budget but were deleted because last year's bipartisan budget agreement did not include any provision for additional revenue initiatives for IRS.

The largest revenue initiative proposed by IRS involved what was to be the third installment of a 3-year examination initiative. As in 1987 and 1988, the initiative would have provided the IRS

with 2,500 additional examination positions. IRS estimated that this initiative would allow it to do 244,000 more audits in fiscal year 1989, with an associated increase in assessed tax, penalties, and interest of $2.8 billion, of which $347 million would be realized in fiscal year 1989.

There were two reasons for giving IRS additional examination resources in fiscal years 1987 and 1988: First, to increase audit coverage; and, second, to generate more revenues. IRS's results during the 1987 phase of the initiative, however, provide conflicting evidence as to how much of an increase in coverage and revenues can really be expected. That is not surprising considering the time it takes for IRS to recruit and train new examiners to the point where they can be fully productive.

The largest increase in the budget is for information technology. IRS is requesting about $992 million in that area, which represents about 19 percent of its total budget, and is an increase of about $137 million, or 16 percent over the amount included in the final approved budget for fiscal year 1988.

A critical issue in this area is IRS's need to redesign the tax processing system because its current ADP systems are outdated and inefficiently designed. To this end, the 1989 budget request includes about $92 million for five projects specifically identified as supporting IRS's long-term effort to redesign the tax processing system. Redesign is expected to take about 10 years to complete and costs several billion dollars. The subcommittee should note that estimates of future costs for redesign projects in this year's budget request could change dramatically because the IRS has not yet decided on a new design for the tax processing system.

IRS cannot determine what the redesign system will cost totally until it has identified alternative designs, conducted cost-benefit analyses and selected a final design.

Other than information technology, IRS's budget includes few program changes. Although we support the thrust of those changes, we have some questions about IRS's contemplated approach to the largest one, which involves a request for $5.8 million and is directed at providing more information to taxpayers on interest and penalty computations. Under this initiative, IRS intends to put a statement on balance due notices sent to taxpayers telling them to write IRS if they want a detailed explanation of the penalty and interest associated with the notices. IRS issues several million of those notices annually and estimates that about 2.5 percent of the taxpayers who receive them request penalty and interest explanations. By adding a statement to the notices, IRS expects this figure to increase to 5 percent.

IRS plans eventually to automatically include penalty and interest explanations on notices when they first go to the taxpayers, thus precluding the need for taxpayers to request that information.

We believe it would be better for IRS to refocus its initiative toward implementing the system that will automatically include explanations on its notices. Also, after seeing a preliminary draft of what IRS might be sending taxpayers to explain penalty and interest charges, we are concerned about the level of detail IRS may be planning to send out.

The draft was several pages long and potentially confusing and could have the perverse effect of causing even more correspondence from taxpayers. We understand that IRS is working to simplify these explanations.

Considering IRS's workload projections for 1989 compared to 1988 and based on IRS's performance in handling its 1988 workload, the 1989 budget appears to include enough staff for returns processing and taxpayer service to provide the same level of service next year as has been provided this year. What is unknown, however, is whether there are sufficient resources to improve the quality of that service.

During the last 2 years, IRS has been involved in a major agencywide initiative to improve the quality of its services by attempting to instill a quality first culture in every phase of its operations. To date, IRS's quality initiative has had a positive impact through a number of successful quality improvement projects.

Our work in the past year, however, has shown there is room for further improvement, especially in the areas of telephone assistance, correspondence with taxpayers, and returns processing.

I will be discussing telephone assistance later. As for taxpayer correspondence, we reviewed correspondence mailed to taxpayers by the adjustments/correspondence branches in three service centers between May 4 and July 31, 1987. Our review showed that IRS's letter, the adjustment discussed in the letter, and/or the action taken by IRS in response to the taxpayer's inquiry was incorrect, incomplete, unresponsive, or unclear about half of the time.

Besides the potentially adverse impact on taxpayer relations, such problems can significantly increase service center costs through the need to process additional correspondence as taxpayers try to get their problems resolved.

With respect to returns processing, information developed during one of our ongoing reviews of IRS showed that service centers devoted as much time in 1986 to correction and quality assurance activities in the returns processing pipeline as it did to initially process the returns. We believe the resources expended in correction will remain high this year because taxpayers and IRS staff are making errors on about 21 percent of the returns filed.

In keeping with IRS's emphasis on quality first, this is an area in which IRS may wish to pay more attention to prevention, through such things as training, taxpayer education, and more easily understood forms, and less on inspection and correction.

I would now like to discuss our monitoring of the 1988 filing season. On February 23, we testified before this subcommittee on the status of the season at that point. Since then, we have continued to monitor IRS's telephone assistance, returns processing, forms distribution, and walk-in assistance. As of April 2, IRS statistics show that its 32 call sites had answered about 15.7 million telephone calls from taxpayers, 12.6 percent more than last year, but 7.8-percent less than IRS had expected.

We have been assessing the accuracy and accessibility of IRS's telephone assistance since mid-February. As of April 1, 1988, we had attempted 1,523 of the 1,927 test calls we will be making to 29 of IRS's call sites. The weighted results of the 1,369 calls for which

we got answers show that we received correct responses to about 62 percent of our calls. The other 38 percent were answered incorrectly.

We were able to reach an assister on the first try 77 percent of the time. The rate increased to 93 percent within five tries.

IRS statistics and our work at 5 of 10 service centers indicate that IRS is processing tax returns at about the same rate as last year. The Commissioner has made this point. Things seem to be flowing fairly smoothly there. The large number of returns yet to be received and processed is typical of past filing seasons, and IRS does not expect any unusual processing delays.

Although IRS has not experienced any major processing difficulties in 1988, we identified a few areas where opportunities seem to exist to improve the effectiveness of future filing seasons. Those areas involved: One, taxpayers filing Form 1040 when they could file the simpler 1040A or 1040EZ; two, returns being filed without the preaddressed label furnished by IRS; three, taxpayers and IRS making errors on about 21 percent of the returns filed this year; and, four, service centers not being able to fully use automatic optical character recognition equipment to process the 1040EZ returns.

We plan to continue analyzing these areas and possible solutions as we complete our monitoring of the filing season.

On February 23, we testified that some of the 233 forms and publications on an IRS ordering list were unavailable to taxpayers at six over-the-counter distribution sites that we visited. Following our testimony, IRS's national office issued a directive that field offices follow proper restocking procedures. We have continued to check on the availability of the 233 documents at distribution sites across the country. Although the availability of documents continues to vary from site to site, in part due to the limited space each site has to stock documents, it appears that overall availability has improved since our testimony. For the 4-week period ended April 8, the number of out-of-stock documents at 5 of the same 6 sites ranged from 2 to 22, compared to a range of 11 to 41 in February.

In February, we started an assessment of taxpayer satisfaction with services provided at IRS's walk-in offices. On 3 days each, in February and March, we surveyed a total of about 1,000 taxpayers who visited 9 walk-in offices in Maryland, Michigan, Washington, Oregon, and the District of Columbia. Our results continue to indicate, as we testified in February, that more than 80 percent of the respondents were generally satisfied or very satisfied with the timeliness and usefulness of IRS's assistance, the clarity of information they received, and the courtesy of the assisters.

In conclusion, IRS has not encountered any serious problems in processing returns this filing season. At the point we last checked, however, millions of returns still had not been filed, so IRS must remain diligent.

One aspect of the filing season that remains troubling is the high rate of incorrect responses to our test telephone calls. That problem, plus other quality problems involving taxpayer correspondence and returns processing, provide evidence of the importance of emphasizing quality.

There are some initiatives in the IRS's 1989 budget directed at improving IRS's service to taxpayers, but none that specifically ad-

dress the problems we have been discussing. The answer to those quality problems may or may not require additional funds, depending on the root causes. The IRS needs to identify those causes and to determine whether additional funds are needed to address them.

Another major issue associated with the 1989 budget is the absence of any revenue initiative. Such initiatives represent attractive vehicles for increasing Government revenues. We would emphasize, however, that if Congress adds enforcement revenues to this year's budget request, it should do so in anticipation of generating the most additional revenues in succeeding years.

That concludes my statement, Mr. Chairman. We will be happy to respond to questions.

[The statement of Mr. Finch follows:]

STATEMENT OF JOHNNY C. FINCH, DEPUTY DIRECTOR, GENERAL GOVERNMENT DIVISION, U.S. GENERAL ACCOUNTING OFFICE

Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to assist the Subcommittee in its inquiry into the status of the 1988 filing season and IRS' budget request for fiscal year 1989. My testimony makes the following points:

-- Our test calls to IRS' telephone assistance call sites have shown little improvement in the accuracy of IRS' answers since we testified in February.

-- IRS has not encountered any unusual problems in processing tax returns this year--the first in which IRS and taxpayers had to implement many of the changes in the Tax Reform Act of 1986.

-- Since our February testimony, the availability of forms and publications at over-the-counter distribution sites has improved.

-- Taxpayers we interviewed are generally satisfied or very satisfied with assistance provided at IRS' walk-in offices.

-- Although IRS' fiscal year 1989 budget includes no initiatives directed at increasing revenues, several were proposed in the submission to the Office of Management and Budget. At the Subcommittee's request, we have some comments on three of those initiatives.

-- Information technology accounts for most of the increase in the 1989 budget.

-- Other than information technology, IRS' budget includes few program changes. Although we support the thrust of those changes, we have some questions about IRS' contemplated approach to the largest one, which is directed at providing more information to taxpayers on interest and penalty computations.

-- We support IRS' recent emphasis on quality. We believe, however, there is room for further improvement in the quality of returns processing and taxpayer assistance. Additional resources may be needed to achieve that end.

I would now like to discuss our monitoring of the 1988 filing season.

## THE 1988 FILING SEASON

On February 23, 1988, we testified before this Subcommittee on the status of the 1988 filing season. Since then, we have continued to monitor IRS' telephone assistance, returns processing, forms distribution, and walk-in assistance.

### Telephone assistance

As of April 2, 1988, IRS statistics show that its 32 call sites had answered about 15.7 million telephone calls from taxpayers, or 62.6 percent of the total calls (25.2 million) received since the first of the year. The number of calls answered is 12.6 percent more than last year, but 7.8 percent less than IRS had expected. Using its formula for converting the total number of calls coming into the call sites (including those resulting in busy signals) to an estimate of taxpayer demand for telephone service and comparing that to the number of calls answered, IRS has determined that its cumulative level of service through April 2, 1988, was 84.8 percent. That result is consistent with IRS' objective of 85 percent and is above the 77.4 percent level IRS says it achieved at the same point in time last year.

We have been assessing the accuracy and accessibility of IRS' telephone assistance since mid-February. As of April 1, 1988, we had attempted 1,523 of the 1,927 test calls we will be making to

29 IRS call sites. The weighted results of the 1,369 calls for which we got answers show that we received correct responses to about 62 percent of our calls. The other 38 percent were answered incorrectly. We were able to reach an assistor on the first try 77 percent of the time. The rate increased to 93 percent within five tries.

Returns processing

IRS statistics and our work at 5 of 10 service centers indicate that IRS is processing tax returns at about the same rate as last year. As of April 1, IRS had processed about 47 million, or 81 percent, of the 58 million individual income tax returns it had received. Those numbers are about the same as this time last year. IRS expects to receive a total of 107 million individual income tax returns during the 1988 filing season (3.7 million more than last year), leaving a little less than half of the total yet to be received. The large number of returns yet to be received and processed is typical of past filing seasons and IRS does not expect any unusual processing delays.

Although IRS has not experienced any major processing difficulties in 1988, we identified a few areas where opportunities seem to exist to improve the effectiveness of future filing seasons. We plan to continue analyzing these areas and possible solutions as we complete our monitoring of the filing season.

-- Some taxpayers are not filing the simplest tax returns possible. For example, an IRS sample of form 1040s filed at the Austin Service Center this year showed that 14.1 percent of the taxpayers could have filed a form 1040A or 1040EZ. Those forms are less costly to process and should be easier for taxpayers to prepare.

-- About 40 percent of the returns filed through April 1, 1988, including about 45 percent of those completed by tax preparers, were filed without the preaddressed label furnished by IRS. This is a slight improvement over last year when about 41 percent of the returns, including about 47 percent of those from practitioners, had no IRS label. IRS statistics show that the most predominant causes of individual income tax returns not posting to taxpayer accounts are errors made either by taxpayers in manually entering information on the return that is already printed on the label or by IRS in transcribing the manually-entered information. Using the label eliminates the need for taxpayers to fill in that part of the return and for IRS to transcribe it, thus enabling IRS to process the return faster, at less cost and with less chance of error.

-- Taxpayers and IRS staff are making errors on about 20.7 percent of the returns filed this year, about 1.4 percentage points higher than last year. Although IRS expected that error rates would increase as taxpayers and returns processing staff adjusted to changes in tax forms and filing requirements, the amount of the increase has been less than expected. Nonetheless, some sections of the revised tax forms seem to cause more problems than others. For example, filers of 1040EZ returns are not always indicating on line 4 whether they can be claimed as a dependent on another person's return. Another source of errors has been taxpayer failure to claim the proper standard deduction on 1040A and 1040EZ returns. Such errors cause additional IRS processing and may delay refunds.

-- IRS service centers are not able to fully use automated optical character recognition equipment to process 1040EZ returns. Each service center had planned to process the returns on two types of automated equipment which, if used,

would speed the processing of these returns and reduce processing costs. Two service center directors told us they are not using either type because one is tied up processing higher priority payments made through the Federal Tax Deposit system while the other has not performed satisfactorily. To avoid delaying refunds, the service centers are relying on more labor-intensive processing methods.

Distribution of forms and publications

On February 23, 1988, we testified that some of the 233 forms and publications on an IRS ordering list were unavailable to taxpayers at six over-the-counter distribution sites. Following our testimony, IRS' national office issued a directive that field offices follow proper restocking procedures. We have continued to check on the availability of the 233 documents at distribution sites across the country. Although the availability of documents continues to vary from site to site, in part due to the limited space each site has to stock documents, it appears that overall availability has improved since our testimony. For the 4-week period ended April 8, the number of out-of-stock documents at five of the same six sites ranged from 2 to 22 compared to a range of 11 to 41 in February.

Many taxpayers also order forms and publications by mail or phone. As of April 1, 1988, IRS statistics show that its three central distribution centers had filled about 98 percent of the approximately 8 million mail and phone orders. IRS advises taxpayers that they can expect to receive documents within 7 to 10 work days after the phone call. To validate that, we placed nine orders for documents explaining tax law changes that IRS estimates will affect 3 million or more taxpayers. The seven orders we received so far were all filled in 7 days or less. Two other orders had not been filled as of April 8--9 and 12 days after we placed them.

Walk-in assistance

In February, we started an assessment of taxpayer satisfaction with services provided at IRS' walk-in offices. On 3 days each in February and March, we surveyed a total of about 1,000 taxpayers who visited 9 walk-in offices in Maryland, Michigan, Washington, Oregon, and the District of Columbia. Our results continue to indicate, as we testified in February, that more than 80 percent of the respondents were generally satisfied or very satisfied with the timeliness and usefulness of IRS' assistance, the clarity of information they received, and the courtesy of the assistors.

When asked whether preparing their tax return this year was easier, harder, or about the same as last year

-- 48 percent of the 892 taxpayers responding to that question said it was harder or much harder,

-- 30 percent said it was about the same, and

-- 12 percent said it was easier or much easier this year.

About 10 percent of our respondents indicated that they were not sure yet how difficult preparing their returns would be.

I would now like to discuss IRS' budget for fiscal year 1989.

IRS' 1989 BUDGET

IRS' proposed budget for fiscal year 1989 totals $5.3 billion and provides for 113,811 average positions, an increase of $240.8 million (4.8 percent) and 1,650 positions (1.5 percent) over the authorized levels for fiscal year 1988. This increase is small

compared to the increases for fiscal years 1987 and 1988. Perhaps the most notable feature of the 1989 budget is the absence of any initiative to increase tax revenues. Of the increases in the budget, the most significant is for information technology. The rest of the program changes are generally aimed at improving IRS' responsiveness to taxpayers.

Revenue initiatives

One major aspect of IRS' budget, considering the trend in recent years, is the absence of any revenue initiative. At your request, we have some comments on three initiatives that were included in Treasury's submission to the Office of Management and Budget. Those initiatives were deleted because last year's Bipartisan Budget Agreement did not include any provision for additional revenue initiatives for IRS.

Examination

The largest revenue initiative proposed by IRS involved what was to be the third installment of a 3-year Examination initiative. As in 1987 and 1988, that initiative would have provided IRS with 2,500 additional Examination positions. IRS estimated that this initiative would allow it to do 244,000 more audits in fiscal year 1989 with an associated increase in assessed tax, penalties, and interest of $2.8 billion, of which $347 million would be realized in fiscal year 1989.

There were two reasons for giving IRS additional examination resources in fiscal years 1987 and 1988--to increase audit coverage and to generate more revenues. IRS' results during the 1987 phase of the initiative, however, provide conflicting evidence as to how much of an increase in coverage and revenues can really be expected. That is not surprising considering the time it takes for IRS to recruit and train new examiners to the point where they can be fully productive. Thus, if the Subcommittee is inclined to recommend that IRS be authorized additional examination resources for 1989, it should do so in anticipation of generating the most additional revenues in succeeding years.

Collection

One of IRS' proposed initiatives for fiscal year 1989 involved 533 average positions and $22.3 million directed at the accounts receivable inventory. IRS estimated that this initiative would generate additional revenues of $94 million in fiscal year 1989. According to IRS, the accounts receivable inventory was $53.5 billion at the end of February 1988 compared to $46.2 billion a year earlier. Numerous questions have been raised as to the collectibility of that inventory and IRS is in the midst of trying to identify, through an internal quality improvement project and a contract with Price Waterhouse, the makeup of the inventory and how much is truly collectible. We believe something needs to be done about the inventory. We understand that the Price Waterhouse study will be available soon. Given this, the Subcommittee may wish to pursue the study findings with IRS when deciding how many, if any, additional resources are needed to reduce the inventory.

International

Another proposed initiative called for $6.6 million and 116 average positions to improve international tax compliance through such things as increased examination coverage and collection efforts. IRS estimated that this initiative would generate $30 million in additional revenue in fiscal year 1989. The initiative included 12 positions to enable IRS to match more of the information returns it receives from foreign countries. We testified on that subject in 1983 before the Subcommittee on

Commerce, Consumer and Monetary Affairs of the House Committee on Government Operations. We believed then that more matching was needed and have no reason to believe otherwise now. To the extent that part of this initiative would lead to that result, we would support that part.

Budget request for information technology

IRS is requesting about $992 million for automated data processing (ADP) and information technology resources in fiscal year 1989. This represents about 19 percent of its total budget and is an increase of about $137 million, or 16 percent, over the amount included in the final approved budget for fiscal year 1988.

A critical issue in this area is IRS' need to redesign the tax processing system because its current ADP systems are outdated and inefficiently designed. To this end, the 1989 budget request includes about $92 million for five projects specifically identified as supporting IRS' long-term effort to redesign the tax processing system. The following table shows, for each of the five projects, the amount included in IRS' 1989 budget request and the estimated costs for 1990 through 1993.

| Projects | Fiscal year 1989 budget request | Estimated costs 1990-1993 |
|---|---|---|
| | (000's) | |
| Tax system redesign mission support | $13,547 | $ 85,659 |
| Full utilization of electronic filing | 32,430 | 60,061 |
| Long-term redesign project | 26,996 | 442,471 |
| Digital image and optical data storage | 3,894 | 69,738 |
| Automated Underreporter Program | 15,185 | 39,104 |
| Totals | $92,052 | $697,033 |

Redesign is expected to take about 10 years to complete and cost several billion dollars. The Subcommittee should note that estimates of future costs for redesign projects in this year's budget request could change dramatically because IRS has not yet decided on a new design for the tax processing system. IRS can not determine what the redesigned system will cost until it has identified alternative designs, conducted cost-benefit analyses, and selected a final design.

Other program changes

IRS' budget contains only a few program increases beyond those for information technology. Those increases are generally directed at improving IRS' responsiveness to taxpayers.

Penalty and interest explanations

One of the program changes in IRS' budget involves a request for 186 average positions and $5.8 million to cover the costs associated with putting a statement on balance due notices sent to taxpayers telling them to write IRS if they want a detailed explanation of the penalty and interest associated with the notices. IRS issues several million of those notices annually and estimates that about 2.5 percent of the taxpayers who receive them request penalty and interest explanations. By adding a statement to the notices, IRS expects this figure to increase to 5 percent. IRS plans, eventually, to automatically include penalty and interest explanations on notices when they first go to the taxpayers, thus precluding the need for taxpayers to request that information.

Our recent work in three service centers indicates that many of the inquiries received from taxpayers relate to penalties and

that some of those inquiries might not have been necessary if the taxpayers had received more information about the penalty portions of their balance due notices. We note also that a recent Taxpayer Bill of Rights approved by the Senate Finance Committee would require IRS, among other things, to more fully describe in its notices the basis for penalty assessments.

We believe, however, that it would be better for IRS to refocus this initiative toward implementing a system that will automatically include explanations on its notices. Also, after seeing a preliminary draft of what IRS might be sending taxpayers to explain penalty and interest charges, we are concerned about the level of detail IRS may be planning to send taxpayers. The draft was several pages long and potentially confusing, and could have the perverse effect of causing even more correspondence from taxpayers. We understand that IRS is working to simplify its explanations.

Problem resolution program

IRS has proposed increasing its Problem Resolution Program (PRP) by 46 average positions (to a total of 299) at a cost of $2 million. PRP's goals are to (1) assist taxpayers in resolving problems that IRS' normal assistance channels failed to resolve; (2) serve as the taxpayers' advocate to ensure they are treated fairly and that their interests and concerns are represented when new policies and programs are being considered; and (3) conduct analyses so that the causes of taxpayer problems can be identified and corrected, thereby preventing future complaints.

In a December 1987 report[1], we concluded that PRP had been successful in achieving its taxpayer assistance objective and that taxpayers were generally satisfied with that assistance. We noted that the number of taxpayers who had their problems resolved through PRP had increased from about 79,000 in fiscal year 1977 to about 555,000 in fiscal year 1986. PRP, however, is not a program that should aspire to growth. Instead, IRS should work to lessen the need for such special assistance by improving normal assistance and by developing a more meaningful problem analysis system to identify and correct the causes of problems.

PRP officials estimate that about 90 percent of program time is spent ensuring taxpayers' problems are being addressed and resolved. They told us that a preferred balance between taxpayer assistance and taxpayer advocacy/problem analysis would be about 70 percent and 30 percent, respectively. In line with that preference, we understand, from our discussions with PRP officials, that the 1989 budget increase will be primarily directed at problem analysis and taxpayer advocacy.

We support additional PRP resources for problem analysis and taxpayer advocacy. Increased problem analysis targeted at correcting recurring problems would be a big step towards ensuring quality service up front where it belongs. This approach should also foster better taxpayer relations and minimize future taxpayer complaints. Ultimately, we would hope that more of PRP's efforts could be aimed at taxpayer advocacy and problem analysis and less at resolving specific problems.

Tax fraud investigations

IRS is requesting $257.6 million and 4,620 average positions--an increase of $13.8 million and 104 average positions--for tax fraud investigations. Over half of the dollar increase is related to ADP and systems modernization. Of the new positions, however, 73 are for the Special Enforcement Program, which is

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[1]Tax Administration: IRS Can Improve on the Success of Its Problem Resolution Program (GAO/GGD-88-12; December 22, 1987).

IRS' primary vehicle for identifying the illegal income of organized crime figures and drug traffickers.

We will soon be issuing a report on that program to the Joint Committee on Taxation. Our study showed that IRS did more Special Enforcement investigations and generated more convictions in 1985 than in 1982. We projected that about half of those investigated were convicted and two-thirds of those convicted received a jail sentence. From a tax administration standpoint, our analysis of the program cases closed for fiscal year 1982--the latest complete data available--showed that about $2 million of the $11 million in tax revenue generated represented taxes on illegal source income. In addition to direct revenue, IRS expects its special enforcement efforts to have an unquantifiable deterrent effect on potentially noncompliant taxpayers.

Because specific goals or evaluation criteria have not been established for the Special Enforcement Program, we could not conclude whether the above results met Congress' or IRS' expectations. Unquestionably, the pursuit of illegal income of organized crime figures and drug traffickers is an important aspect of IRS' tax fraud investigation effort. However, the Subcommittee may want to explore with IRS how the additional resources it is requesting will be used in the short term and how they will contribute to IRS' long term strategy in this area.

Adequacy of budget for returns processing and taxpayer service

Considering IRS' workload projections for 1989 compared to 1988 and based on IRS' performance in handling its 1988 workload, the 1989 budget appears to include enough staff for returns processing and taxpayer service to provide the same level of service next year as has been provided this year. What is unknown, however, is whether there are sufficient resources to improve the quality of that service.

During the last 2 years, IRS has been involved in a major agency-wide initiative to improve the quality of its services by attempting to instill a "quality first" culture in every phase of its operations. Among other things, that initiative has involved development of the Commissioner's Quality Council, quality training for managers of all levels in IRS, a joint IRS-employees union agreement making the union a partner in the quality effort, and initiation of numerous quality improvement projects. We support this effort and believe that enhancing quality will not only improve IRS' service to the public but also help reduce the current cost of quality.

To date, IRS' quality initiative has had a positive impact through a number of successful quality improvement projects. Our work in the past year, however, has shown there is room for further improvement, especially in the areas of telephone assistance, correspondence with taxpayers, and returns processing.

Telephone assistance

As noted earlier, our test of IRS' telephone assistance this year indicates that 38 percent of IRS' answers were incorrect. This year's results, through April 1, are lower than the results from previous years. Although our results do not necessarily reflect the overall accuracy of IRS assistors' answers to the full range of questions asked by taxpayers, we believe the questions we asked are reasonable and among those likely to be asked by taxpayers. One possible explanation for this year's lower accuracy rate is the fact that about 60 percent of IRS' assistors are new hires. We expect to continue working with IRS to measure trends in and identify ways to improve the quality of IRS' telephone assistance program.

Taxpayer correspondence

Each year, the Adjustments/Correspondence Branches in IRS' 10 service centers send millions of letters to taxpayers either in response to the taxpayer's inquiry or to advise the taxpayer of an adjustment to his or her account. IRS' handling of that correspondence can have a critical impact on taxpayer relations. Our review of correspondence cases closed by three service centers between May 4 and July 31, 1987, showed that IRS' letter, the adjustment discussed in the letter, and/or the action taken by IRS in response to the taxpayer's inquiry was incorrect, incomplete, unresponsive, or unclear about half of the time. In about 30 percent of the cases reviewed, we considered IRS' error critical because the case involved at least one instance in which the Adjustments/Correspondence Branch either provided incorrect information, failed to address all the taxpayer's questions, or acted incorrectly in adjusting or failing to adjust the taxpayer's account.

Besides the potentially adverse impact on taxpayer relations, such problems can significantly increase service center costs through the need to process additional correspondence as taxpayers try to get their problems resolved. Our preliminary observations indicate that improvements might be possible through better training and supervision. In addition, IRS may also need to consider whether the minimum requirements to qualify as a tax examiner in the Adjustments/Correspondence Branch have to be revised and whether the production standards being used allow for quality service. We will soon be discussing these preliminary observations with IRS.

Returns processing

Information developed during one of our ongoing reviews of IRS showed that service centers devoted as much time in 1986 to correction and quality assurance activities in the returns processing "pipeline" (14.4 million staff hours) as it did to initially process returns. We believe the resources expended in correction will remain high this year because taxpayers and IRS staff are making errors on about 21 percent of the returns filed. These errors include those made by taxpayers as well as IRS personnel and, for the most part, are simple errors (such as math errors, a failure to enter the standard deduction, and a failure to accurately transcribe taxpayer information) rather than errors caused by tax law complexity. In keeping with IRS' emphasis on "quality first", this is an area in which IRS may wish to pay more attention to prevention (through such things as training, taxpayer education, and more easily understood forms) in contrast to inspection and correction.

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There is nothing in the 1989 budget that is specifically identified as IRS' answer to the quality issues discussed above. There are some items in the budget, however, that could have an impact in those areas. Two information technology initiatives--electronic filing and the Automated Taxpayer Service System--could have a positive impact on improving the quality of returns processing and taxpayer service respectively. Statistics on electronic filing, for example, indicate that the error rate associated with returns processed through that system (8 percent) is considerably lower than the rate associated with returns processed through the traditional process (about 20 percent). To the extent better training is the answer, funds already included in the budget for that activity may be sufficient because the solution may involve using available funds to provide better training rather than getting more money for more training. Other possible solutions, however, could require additional funds. For example, if it is deemed unreasonable to expect relatively low-

salaried employees to deal with the complexities involved in answering telephone inquiries and taxpayer correspondence, the answer would seem to lie in upgrading those positions. Doing that could require an increase in IRS' budget in the short term but should, if IRS' level of quality improves, eventually lead to savings by reducing the amount of quality assurance and rework necessary.

U.S. TAX COURT

You also asked for our comments on the U.S. Tax Court's budget for fiscal year 1989. That budget totals $29.3 million, an increase of $1.8 million (6.7 percent) over fiscal year 1988. About two-thirds of the requested increase is for a new cooling system for the Tax Court Headquarters building. The remainder is for increased rent charges, personnel compensation and benefits, and other cost adjustments. The proposed budget requests no additional staff positions.

In fiscal year 1987, after many years of increasing inventories, the Tax Court closed more cases than it received. Thus, the closing inventory of cases for fiscal year 1987 decreased by 3 percent to a level of 81,549 cases. Through February 1988, Tax Court records show that this trend is continuing. Filings have decreased 25 percent while the number of cases closed has increased by 20 percent over the same period last year. The Tax Court's inventory was down to 72,383 cases as of the end of February 1988. Tax Court officials attribute the decrease in filings to such things as (1) a provision in the Tax Equity and Fiscal Responsibility Act of 1982 which allows IRS to resolve tax shelter cases by dealing with the designated partner for tax matters rather than with individual investors and (2) IRS' encouragement to settle cases before a taxpayer petitions the Tax Court. The Tax Court expects that it will continue closing more cases than it receives during the rest of fiscal year 1989.

Although the Tax Court's inventory of cases is declining, it is unclear whether this trend will continue in future years. For example, the Taxpayer Bill of Rights passed by the Senate Finance Committee includes provisions expanding the jurisdiction of the Tax Court. Also, problems associated with implementing the massive changes in the Tax Reform Act of 1986 and increases in Examination staff as a result of the 1987 and 1988 revenue initiatives could have an impact on the Tax Court's workload.

CONCLUSION

In conclusion, IRS has not encountered any serious problems in processing returns this filing season. At the point we last checked, however, millions of returns still had not been filed so IRS must remain diligent. One aspect of the filing season that remains troubling is the high rate of incorrect responses to our test telephone calls. That problem, plus other quality problems involving taxpayer correspondence and returns processing, provide evidence of the importance of emphasizing quality.

There are some initiatives in IRS' 1989 budget directed at improving IRS' service to taxpayers but none that address the problems we have been discussing. The answer to those quality problems may or may not require additional funds depending on the root causes. IRS needs to identify those causes and to determine whether additional funds are needed to address them.

Another major issue associated with the 1989 budget is the absence of any revenue initiative. Such initiatives represent attractive vehicles for increasing government revenues. We would emphasize again, however, that if Congress adds enforcement resources to this year's budget request it should do so in anticipation of generating the most additional revenues in succeeding years.

That concludes my prepared statement. We will be happy to respond to any questions.

Mr. DORGAN [presiding]. Thank you very much, Mr. Finch. Chairman Pickle?

Chairman PICKLE. Mr. Finch, I thank you for your testimony and I thank you for the GAO's investigation in this wide area. We asked for your help because we are trying to make an evaluation of what exactly is happening down the street.

It is not that we do not rely "totally" on their report to us. We just want to get an independent counsel or get the GAO to review it, and we think you have given us some very valuable information. I appreciate your dedication to this effort.

Now let me ask you first about the telephone accuracy. You show that as of almost 2 months ago they had an accuracy rate of only about 61 percent. Now you say after 1,500 phone calls, their accuracy is about 62 percent. In other words, they have improved about 1 percent. I think the IRS shows improvement of about the same percentage, on their final figure, although there is a 10-percent difference between what you claim and what they claim.

That is not acceptable and we have got to do better. I think it is important though, that they keep saying that it is 100 percent based on what they called a completely accurate answer, and I think that is something for us to keep in mind.

Commissioner Gibbs, a few minutes ago, testified that he was hoping that if we go forward in these kind of appraisals, that GAO and IRS could get together and agree on a similar form or the same questions or type of questions. Would that be helpful? Have you talked to each other about what each would want? Is your request for us different from what they wanted to give? Is there a possibility or should we get together on a common form or survey?

Mr. FINCH. Mr. Chairman, the issue has arisen, but we really have not discussed it at length, yet. I think there is potential for us to arrive at perhaps one approach to making the phone calls. I think we need to have a lot more discussion in terms of exactly what that approach might be.

One possibility, and I just throw this out as one thing that we would like to discuss both with you and IRS at greater length, would be for IRS to come up with a methodology. Perhaps we could look at that methodology and say that we think the methodology is okay and then monitor it.

We could perhaps put together a plan that we could come back and discuss with the subcommittee before we implement it.

Chairman PICKLE. I hope that you do talk with them and perhaps there is some common ground that we could include in any one survey. I have the feeling, though, that you are going to be asking for specific information that we are requesting and they are going to ask a different type of question. I doubt that it would be completely the same.

If it was the same, there is no point in duplicating the same questions. But to the extent that you would have the best coverage of important questions, I think that would be helpful.

In the area of examination appeal, you said in your testimony that OMB had not included this third year planned examination revenue initiative and that is true. My question is if they did not have this thing, is there any indication now that the Internal Reve-

nue Service will not have enough agents to actually raise the amount of monies to meet the 1988 revenue target?

Commissioner Gibbs said oh yes, we will be able to meet it with no problem. Is this going to be a problem?

Mr. FINCH. I do not know that I can answer that definitively, sir. Let me try it this way. They actually exceeded their estimates for 1987, in terms of the revenue that they would generate, by about $3 billion. But the flip side of that is that audit coverage went down in the process.

Chairman PICKLE. What went down?

Mr. FINCH. Audit coverage. The percentage of returns examined went down in the process.

So I think the issue is really one of a double edged sword. It could be that the revenue estimate was conservative to begin with. There could be a problem with the revenue estimate and we are looking at how they go about making those estimates now.

The other side of that is the audit coverage. If they do not get additional resources and the audit coverage keeps dropping, it is my opinion that it could have an effect on the quality of exam as a tool to combat noncompliance.

Chairman PICKLE. You are saying, if I can analyze your answer, is that when they did away with the third year examination, that this created a problem, not only in the fact that you had a lack of personnel in that division, but also because of other people being transferred from other sections into other duties, including audits. And that might reflect a possible danger in that area, too.

So it could work both ways, could it not?

Mr. FINCH. That is true.

Chairman PICKLE. In your testimony, you said that there is a substantial lag between the start of an enforcement initiative and the point in which additional revenue is actually being collected. Do you have any suggestions how they could correct that? Is that unavoidable delay lag in there?

Mr. FINCH. I think a lot of it is unavoidable, sir. Some of it depends on the speed with which the appropriations process moves and the point in time when IRS knows it has the money and can commit to making offers of employment.

Chairman PICKLE. Mr. Finch, I am going to yield to Mr. Dorgan. I want to say to you that we have got a lot of questions we are going to submit to you. We want you to answer them in writing and we will follow through on it.

Your survey has been helpful. We want answers from you in such areas as return, processing and computers. I would like to know if GAO has reached any conclusion about why the quality of the IRS correspondence is so poor. I want your own opinion about some of these questions and we are going to be relying on you for further examination in this whole wide area, too.

Mr. FINCH. Certainly, sir.

Chairman PICKLE. Thank you, Mr. Dorgan.

Mr. DORGAN. Mr. Chairman, thank you.

Mr. Finch, I just have a couple of questions and, as the chairman indicated, questions will be submitted to you for your answers.

The Internal Revenue Service employees who are still in the room need to know, I think, and hear from us that while I am very

supportive of the efforts of the Internal Revenue Service to better enforce the tax laws and to provide better assistance to taxpayers, I am mortified by the statistics that I hear from the GAO. The IRS needs to know that those statistics and that experience is completely unacceptable.

It is not something that we, in Congress, or the American people can or should accept when the GAO says that the taxpayer inquiries to the Internal Revenue Service were replied to and that nearly 50 percent of the time the reply was incorrect, incomplete, unresponsive or unclear.

If 50 percent of the replies from the Internal Revenue Service to the taxpayers is either incorrect, incomplete, unresponsive, or unclear, that is totally unacceptable in my judgment. Something needs to be done and something dramatic needs to be done by the Service to deal with that problem.

The second reference in your testimony on telephone assistance, which has been aired before by this subcommittee, demonstrates ~~that~~ 38 percent of those calling the Internal Revenue Service have received incorrect answers to their questions, again completely unacceptable in my judgment.

I say that having personally run a tax agency, obviously much, much smaller than the Internal Revenue Service. But if I, in my agency, had had a report that said half of the questions asked by taxpayers in letters to my agencies were responded to either without clarity or without accuracy, I would have had a seizure. That is just unacceptable behavior.

Some 38 percent, nearly 40 percent of the telephone calls, the inquiries, are answered incorrectly. I would have been in a rage.

So I want the Internal Revenue Service people here, and the Commissioner knows because I have told him, that while I am very supportive of what they are trying to do, and I think they have made some progress in some areas, these statistics are shocking to us and we are not willing to accept that kind of work at the Service in the area of those who respond to taxpayers.

Can you amplify at all on what you think the reasons are for the information that you have submitted and the incorrect responses to letters and telephone calls that taxpayers have received?

Mr. FINCH. We can give you some preliminary observations, sir, and I think the Commissioner has put his finger on some of them in his earlier responses to you.

I do not think there is any one single factor, I think it is a combination of things. I think certainly grades and salaries may be an issue. The tax system has become extremely complex and some of the questions are befuddling. The salaries that we are offering for those people to answer the phones and to make adjustments to taxpayer accounts and generate correspondence do not really seem to be in keeping, perhaps, with the duties assigned.

So I think that is one thing that may need to be looked at.

Mr. DORGAN. Mr. Finch, one could reasonably anticipate 90 percent of the questions you are going to get when you put somebody on the phone, I would guess. If you and I were selecting someone to begin on the phone this afternoon, answering taxpayer's inquiries, we could reasonably anticipate what most of the questions are going to be, and we could sit across the table from that prospective

telephone respondent and ask those questions to find out whether that particular person had the ability to answer those questions adequately and accurately.

Did you find that the training, preparation and screening for the employees who are going to use that telephone and respond to letters is adequate or inadequate?

Mr. FINCH. We do have observations in that area, sir, both in training and in supervision. We think some of the training materials perhaps could be changed, and that supervisors could do perhaps more indepth reviews than they do. In terms of the way the correspondence is generated, the tax examiner picks and chooses from pre-written paragraphs. Some paragraphs are required, depending on what the tax problem is or what the question is. Other paragraphs are optional.

The examiner calls these paragraphs up, but he only sees the number or the alpha designation of the paragraph. He never sees the complete letter, in its entirety, that he's sending out. Once he's selected the paragraphs, the letter then is printed somewhere else, so he still does not see it.

Mr. DORGAN. On the inquiries that you made as part of your sample, for both telephone and letter, were the inquiries boilerplate, routine kinds of questions, or did you come up with byzantine, complex tax questions that could predict a 40 or 50 percent inaccuracy rate?

I could conceive of getting a 50 percent inaccuracy from the IRS if I were given a little time and a little resourcefulness to make the inquiry. I could come up with that result.

But do your telephone calls and your inquiries that would get a letter in response, represent the kinds of things that the person on the telephone or the person responding to letters would normally receive?

Mr. FINCH. Yes, sir, they do and IRS agrees that they do. We bounced our telephone questions off of IRS. They agreed these were reasonable questions to expect during the filing season and they agreed on the answer that their assisters should give.

Mr. DORGAN. So most of them would be pretty much boilerplate questions, I assume, right?

Mr. ATTIANESE. Can I clarify something?

Mr. DORGAN. Questions that Members of Congress might be able to answer, or might not?

Mr. FINCH. Certainly.

Mr. ATTIANESE. In the correspondence situation, it was not us making up our own correspondence. We were just reviewing IRS' responses to actual correspondence.

Mr. FINCH. No, my answer related just to the telephone questions that I thought your question was directed at.

Mr. DORGAN. The GAO has performed a very useful service to us and I am sure the Internal Revenue Service does not like the result in this area, although there are things going on there that are to be complimented. This is something that I think they should understand Congress wants corrected.

It is not good management, in my judgment, to allow this to happen and it can be prevented. You do not have to put people on telephones who are not prepared to answer questions. There are

some simple screening processes, some management steps that you can establish that prevent that from happening. To the extent that is not done now, I hope it is done. I have communicated that previously to the Commissioner.

You have performed a service in these areas pointing out what the issues are and how we might correct them.

I would like, Mr. Finch, to simply submit on behalf of the subcommittee the remaining questions to you and thank you very much for your testimony.

I believe that concludes the hearing this morning. Thank you very much.

[Whereupon, at 12:42 p.m., the hearing was adjourned.]

[Subsequent to the hearing, additional questions were directed to the U.S. Tax Court and the U.S. General Accounting Office. Those questions and answers follow. Also included are recommendations from the Committee on Ways and Means to the House Appropriations Committee regarding fiscal year 1989 appropriation levels for the Internal Revenue Service.]

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April 15, 1988

The Honorable Samuel B. Sterrett
Chief Judge
United States Tax Court
Washington, D.C. 20217

Dear Judge Sterrett:

I want to thank you for your testimony at the Oversight Subcommittee's hearing on the Administration's Fiscal Year 1989 budget proposals relating to the Internal Revenue Service and the United States Tax Court. To complete our hearing record, I would appreciate having your responses to the following questions by the close of business Friday, April 29, 1988:

1. The number of cases pending in the Tax Court at the end of FY 1987 was 81,549. You testified that the Tax Court's inventory will decrease to approximately 65,000 cases by the end of FY 1988.

   * What do you consider to be an acceptable Tax Court inventory?

   * To what extent has the FIFO calendaring procedure contributed to the reduction in the backlog of cases?

   * What steps, if any, are you planning to take in the future to ensure the backlog continues to decline?

   * The IRS Tax Litigation and Appeals Divisions' ending inventories are expected to increase in FY 1989. What is the relationship between those inventory levels and the Tax Court's docketed inventory?

2. Your statement indicates that 20% of the docketed Tax Court cases are "sitting on the sidelines" awaiting the final resolution of so-called "test cases". You also noted that it takes 14.1 months to render an opinion after the case is tried.

* How many test cases have been tried and briefed and are currently awaiting an opinion?

* How many docketed cases could be disposed of if the Tax Court issued an opinion in these test cases?

* To what extent is the declining inventory attributable to the use of the so-called "project litigation" concept?

3. The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) created a new "unified" procedure for partnership examinations under which the audit of "partnership items" is conducted in a single proceeding at the partnership level.

   * How has the unified partnership proceeding affected the Tax Court's inventory?

   * When the Tax Court renders its decision in the partnership proceeding the ruling will generally have an impact on individual partners' tax liabilities. At the conclusion of many TEFRA partnership cases, the IRS will subsequently issue statutory notices of deficiency to each partner with regard to so-called "affected items" (i.e., penalties, etc.). Do you believe the issuance of "affected item statutory notices of deficiency" will dramatically increase in the number of docketed cases?

4. It is our understanding that additional special procedures have been used by the IRS, taxpayers, and the Tax Court to supplement the project litigation concept. For example, implicit in the concept of the litigation project approach is that multiple trials are avoided by having all parties involved adhere to the results of the lead case or cases selected for trial. Even if taxpayers with related docketed cases do not sign a stipulation to be bound, also called a "piggyback agreement", before a lead case is litigated and decided, the Tax Court's decision may effectively consider and dispose of all the issues pertaining to taxpayers who have not agreed to be bound. Instead of relitigating identical issues in cases, the IRS can file a motion for an order to show cause why the facts and law in the decided case should not govern the case at bar.

* How effective is the project litigation approach in reducing the Tax Court's inventory?

* Have the use of "piggyback agreements" and motions to show cause been successful in avoiding or reducing additional trials?

* Have these procedures been incorporated into the Tax Court Rules and Practice and Procedure? If not, should they be?

* Have there been any problems associated with the use of these procedures?

Your attention to this matter is greatly appreciated. If any assistance is needed, please contact Patrick Heck at 225-5522.

Sincerely,

J. J. Pickle, Chairman
Subcommittee on Oversight

JJP/phl

UNITED STATES TAX COURT
WASHINGTON, DC 20217

CHAMBERS OF
SAMUEL B. STERRETT
CHIEF JUDGE

April 27, 1988

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Subcommittee on Oversight

HAND DELIVERED

Honorable J. J. Pickle
Chairman, Subcommittee on Oversight
Committee on Ways and Means
United States House of Representatives
1105 Longworth House Office Building
Washington, D.C. 20515

Dear Congressman Pickle:

This past Monday I received your letter dated April 15, 1988 in which you pose four series of questions related to the Tax Court's case inventory. The purpose of this letter is to respond to those questions.

(1) I do not think it is possible to quantify an "acceptable" inventory. While it is unquestionably the Court's responsibility to be as efficient as possible in resolving tax disputes, consistent, of course, with the dictates of justice, in the final analysis our inventory depends on the number of deficiency notices issued by the Commissioner and the number of petitions filed by taxpayers in response thereto. As you know, the Court has no control over either of these matters. I can tell you that we are in control of our inventory, and I can illustrate this point by the fact that at the present time no overtime work is routinely required of the personnel in the Clerk's Office. When the Court's inventory peaked in October 1986 at 84,007 cases, Clerk's Office personnel were working 6 days a week. Our inventory now has dropped below 70,000 cases.

Although the FIFO method of calendaring cases has contributed to the reduction of the Court's inventory, the more important factor has been the Court's practice of setting large numbers of cases for trial at the various trial sessions scheduled throughout the country. In fact, it is the scheduling of cases for trial that is the single most important factor in the disposition of cases, whether such disposition is by trial or settlement.

Given the direct correlation between the scheduling of cases for trial and the disposition of cases, the Court intends to continue holding approximately 40 regularly-scheduled sessions per term for the Judges and approximately 45 to 50 regularly-

scheduled trial sessions per term for the Special Trial Judges. Using the FIFO method, a significant number of cases will be calendared for trial at each session and we expect to achieve further reductions in our inventory.

Any increase in the inventories of the IRS Tax Litigation Division and the Appeals Division will not necessarily affect the Court's inventory. As I mentioned earlier, our inventory is ultimately dependent on the issuance of deficiency notices by the Commissioner and the filing of petitions by taxpayers. If an increase in IRS inventories leads to the issuance of a greater number of deficiency notices, I would expect an increased number of filings in this Court, but not necessarily on a proportionate basis.

(2) Approximately 35 test cases have been tried and briefed and are currently awaiting opinion. All of these test cases relate to tax shelters.

The number of cases controlled by any particular test case varies from group to group. We have had a few test cases which have each controlled well over 1,000 other cases. The average, however, is more modest. As one might expect, test cases are generally appealed to the various Courts of Appeals. Our existing inventory includes a considerable number of cases the ultimate disposition of which will depend on the ruling by the Courts of Appeals.

The "project litigation" concept is really a facet or variant of the test case approach. Under this concept, cases comprising the "project" are formally assigned to a particular Judge soon after they are identified as belonging to the project. Because of the Judge's early involvement in managing these cases, settlement is often successfully achieved. As a consequence, it can be said that the "project litigation" concept has positively affected the Court's inventory.

(3) At present there are approximately 2,000 TEFRA "partnership action" cases pending with the Court. There is no way to determine how many partners there are in each of the partnerships or how many of the partners would have commenced a case in this Court in the absence of a unified partnership proceeding. There is no question, however, that the TEFRA approach to partnership actions has reduced what the Court's inventory would otherwise have been.

In the complete absence of any empirical data, I hesitate to predict whether the Court's inventory will be dramatically affected by the issuance of deficiency notices in respect of "affected items." Historically, only a relatively small percentage of taxpayers who receive notices of deficiency have

filed petitions with the Court. I just can not predict whether this same pattern will prevail when it comes to deficiency notices in respect of affected items.

(4) Approximately 60 percent of the Court's existing inventory involves tax shelters. The "project litigation" approach has improved our efficiency in the processing of these cases. All related cases are assigned to a Judge for trial or other disposition soon after they are identified as belonging to the same "project." As I mentioned above, settlement is often successfully achieved because of the Judge's early involvement in managing these cases.

The use of "piggyback agreements" has been particularly effective in disposing of tax shelter issues in large numbers of cases without the need for trial. Motions for orders to show cause have also been used for this purpose. However, piggyback agreements are so common that motions for orders to show cause are of secondary importance.

The Court's existing Rules provide for motions for summary judgment, and it is such motions that successful litigants typically use to enforce "piggyback agreements" if the adversary fails to execute a settlement agreement after a test case is decided. The Court's existing Rules do not specifically provide for motions for orders to show cause. However, it does not appear that a specific rule is necessary. A motion for an order to show cause represents a procedural technique that has been used in this Court for some time and it is not unique to tax shelter cases.

As I mentioned above, "piggyback agreements" are commonly used to resolve tax shelter issues in large groups of related cases. We are not aware at this time of any problems that exist with respect to this procedure.

I hope that the foregoing will be helpful to you in completing your work. If anything more is needed, I stand ready to assist in any way I can.

Very truly yours,

Samuel B. Sterrett

Samuel B. Sterrett
Chief Judge

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April 18, 1988

The Honorable Charles A. Bowsher
Comptroller General of the United States
United States General Accounting Office
441 "G" Street, N.W.
Washington, D.C. 20548

Dear Mr. Bowsher:

I want to thank the United States General Accounting Office for testifying at the Subcommittee on Oversight's hearing on the Administration's Fiscal Year 1989 budget proposals relating to the Internal Revenue Service and the United States Tax Court. To complete our hearing record, I would appreciate having your responses to the following questions by the close of business, Friday, May 13, 1988:

1. Would you support additional increases in funding for certain accounts over the FY 1989 OMB budget request? If so, which accounts?

2. Is there any current shift in resources or demand for resources indicative of a problem next year which the FY 1989 budget does not solve?

3. Your testimony for the past two years had indicated the importance of a complete analysis of the IRS's accounts receivable inventory in order for IRS to efficiently allocate resources within the agency. The accounts receivable inventory had risen to over $53 billion as of the end of February 1988.

   (a) Has the Service made any progress in determining which funds are collectable?

   (b) As a result of the additional Collections staff proposed in the FY 1989 budget, will the accounts receivable inventory decline, remain constant, or continue to increase?

4. GAO reported at our February 1988 hearing that its review of telephone assistance in 1988 showed the IRS was completely correct in its response only 61 percent of the time. Since that report, you have found that the accuracy rate has improved by only 1 percent.

   (a) Why do you believe the accuracy rate has not improved?

   (b) How do each of the following impact on the accuracy level: ratio of permanent to seasonal employees; OPM pay structure and/or grade level; employee training; and, production standards and/or quotas?

   (c) What can be done to improve the accuracy of telephone assistance?

   (d) Do you believe approval of the FY 1989 budget request for Taxpayer Service will allow IRS to significantly improve the ability of its telephone assistance staff to accurately answer questions next year?

5. In your testimony you indicate that there are serious quality and accuracy problems in the area of IRS correspondence.

   (a) Have you reached any conclusions as to why the quality of IRS correspondence is so poor?

   (b) What is the impact of production quotas on quality in the area of correspondence?

   (c) Have you reached any conclusions on the cost to taxpayers and to the IRS for correcting these errors?

   (d) What can be done to improve the quality of correspondence?

   (e) Do you believe approval of the FY 1989 budget request for Returns Processing will allow the IRS to significantly improve the quality of its correspondence?

6. How can the quality and productivity of IRS service center operations be improved? Are improved training courses and management guidelines needed?

7. With regard to the importance of converting seasonal employees to permanent employees, the percentage of new hires has increased by 10% each year from 45% in 1985 to 65% last year.

   (a) Do you see that pattern continuing?

(b) Did you study the cost-to-yield benefit ratio, due to increased efficiency, of a program to convert seasonal employees to permanent employees? If so, what are your findings?

8. In your testimony you point out that redesigning the tax processing system is critically important because IRS's Automated Data Processing systems are outdated and inefficiently designed.

(a) Recognizing that the IRS is still at a very preliminary stage in its Tax System Redesign Project, is the IRS approaching this project in a proper, thorough and systematic way?

(b) Does the Administration's proposed FY 1989 budget provide a reasonable level of funding for the Service's Tax System Redesign efforts?

9. At our February 1988 hearing, GAO continued to raise concerns about the ability of IRS service center computers to handle their projected workloads in the 1992 to 1994 time frame.

(a) Has the IRS supplied you with their proposals for meeting this service center computer "capacity gap"?

(b) If so, have you had an opportunity to evaluate these proposed responses, and will they be effective?

10. For the past several years the Oversight Subcommittee has carefully monitored the progress of the IRS's efforts to replace front-end processors in its ten service centers. Earlier this year, the new equipment was installed in the Fresno and Austin Service Centers.

(a) Is the equipment operating successfully in these first two locations?

(b) Is the IRS replacing the front-end processors at all the other service centers by January 1989?

Your attention to this matter is greatly appreciated.

Sincerely,

J. J. Pickle, Chairman
Subcommittee on Oversight

JJP/sa

GAO

United States
General Accounting Office
Washington, D.C. 20548

General Government Division

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MAY 17 1988

Ways and Means
Subcommittee on Oversight

B-231217

May 17, 1988

The Honorable J. J. Pickle
Chairman, Subcommittee on Oversight
Committee on Ways and Means
House of Representatives

Dear Mr. Chairman:

On April 18, 1988, you asked us to respond to several questions relating to our April 13 testimony on IRS' budget request for fiscal year 1989. The enclosure responds to the first seven of those questions. Our Information Management and Technology Division will be responding separately to the remaining questions.

If you or members of the Subcommittee have additional questions, please contact us.

Sincerely yours,

Jennie S. Stathis

Jennie S. Stathis
Associate Director

Enclosure

ENCLOSURE

ENCLOSURE

1. Would you support additional increases in funding for certain accounts over the FY 1989 OMB budget request? If so, which accounts?

GAO Response

IRS' fiscal year 1989 budget represents a relatively small increase in resources compared to the increases over the past 2 years. IRS expects to provide essentially the same level of service in 1989 as experienced in 1988. Without knowing the root causes of the quality problems relating to telephone assistance, taxpayer correspondence, and returns processing cited in our testimony, it would be premature for us to comment on whether additional funding would be required to address these problems and how the funding might be best spent. In view of the budget deficit, however, we would support increases in IRS' budget that would produce higher revenues.

There were several initiatives in the budget submission to OMB that would, according to IRS' estimates, generate additional revenue. With respect to those initiatives, which OMB deleted from IRS' budget request, we would specifically support the examination initiative and that part of the international initiative directed at enabling IRS to match more information returns received from other countries. Support for the examination initiative is based on our belief that (1) an audit coverage of about 1.27 percent, which is what IRS expects to achieve in fiscal year 1989, is too low to provide an effective deterrent and (2) additional audits will generate increased revenue, although not necessarily the amount of additional revenue forecast by IRS. Also, considering the time it takes IRS to recruit and train new revenue agents to the point where they can be fully productive, it may be unreasonable to expect significant results in fiscal year 1989 if Congress should decide to authorize additional examination positions for IRS. We are currently assessing IRS' examination yield estimates at the Senate Budget Committee's request.

2. Is there any current shift in resources or demand for resources indicative of a problem next year which the FY 1989 budget does not solve?

GAO Response

We are not aware of any major shifts in personnel between and among budget activities that would suggest the need for similar shifts in fiscal year 1989.

3. Your testimony for the past two years had indicated the importance of a complete analysis of the IRS's accounts

receivable inventory in order for IRS to efficiently allocate resources within the agency. The accounts receivable inventory had risen to over $53 billion as of the end of February 1988.

a. Has the Service made any progress in determining which funds are collectable?

b. As a result of the additional Collections staff proposed in the FY 1989 budget, will the accounts receivable inventory decline, remain constant, or continue to increase?

GAO Response

IRS has initiated numerous projects designed to improve the accuracy of information on the collectability of its accounts receivable. Some of these projects deal with specific problems and should improve the accuracy of accounts receivable data in the near future. Other projects are much broader and it is not expected that the full effect of these projects and any proposed changes will be recognized in the short term. For example, IRS has contracted with Price Waterhouse to study the definition and composition of the accounts receivable inventory and to propose a concept for a total accounting system. Field work on this project is in its final stage, and results are expected within the next month or two. Until then, it is unknown how long it will take to implement any proposed changes.

It is too early to tell whether the combined results of all the current projects will have the desired effect of accurately portraying the collectability of the accounts receivable inventory. However, IRS' actions to date represent a good start in that direction and should result in a significant improvement in the reporting of accurate information.

Although historically IRS has collected increasingly more delinquent taxes each year, the accounts receivable inventory has continued to grow. In fiscal year 1987, for example, IRS collected $22.8 billion, an increase of $3.2 billion over the $19.6 billion collected in the prior year. At the same time, however, the inventory of accounts receivable increased by $6.1 billion, from $47.6 billion in fiscal year 1986 to $53.7 billion in fiscal year 1987. Assuming no changes are made in the way accounts receivable are classified and reported, it is our best estimate that, based on the collection resources proposed for fiscal year 1989, the accounts receivable inventory will continue to increase. In that regard, although IRS' fiscal year 1989 budget calls for an increase of 45 average positions, that increase is to be allocated to collection programs other

than accounts receivable. More specifically, the 1989 budget reflects a decrease of 35 positions for accounts receivable compared, for example, to an increase of 67 positions for delinquent returns investigations.

4. GAO reported at our February 1988 hearing that its review of telephone assistance in 1988 showed the IRS was completely correct in its response only 61 percent of the time. Since that report, you have found that the accuracy rate has improved by only 1 percent.

   a. Why do you believe the accuracy rate has not improved?

   b. How do each of the following impact on the accuracy level: ratio of permanent to seasonal employees; OPM pay structure and/or grade level; employee training; and, production standards and/or quotas?

   c. What can be done to improve the accuracy of telephone assistance?

   d. Do you believe approval of the FY 1989 budget request for Taxpayer Service will allow IRS to significantly improve the ability of its telephone assistance staff to accurately answer questions next year?

GAO Response

GAO's previous tests of the accuracy of the taxpayer telephone assistance program have not shown significant variances in the accuracy rate during a single filing season. There generally has been a small improvement in the accuracy rate at the close of each season similar to the small overall improvement in the rate this year. We have not specifically studied the reasons for this relatively stable rate but can offer possible explanations for the pattern. First, the filing season is relatively short, and there is no time for dramatic change following the initial training program. Ongoing training efforts in the field may be hampered to the extent that assistors are sent home when the actual volume of calls falls below the volume expected by IRS. It also may be difficult to identify and correct mistakes by assistors despite efforts by managers to monitor calls. The two general categories of mistakes involve substantive errors and mistakes due to a failure to "probe". Mistakes due to a failure to probe or gather sufficient background information before giving an answer may require different training and/or corrective efforts than errors made in interpreting substantive aspects of law.

As for the impact of various factors on accuracy levels, we have the following comments.

Ratio of Permanent to Seasonal Employees We do not have data analyzing the comparative performance of seasonal and permanent employees. IRS believes that the high turnover of seasonal staff leads to lower accuracy rates and is, therefore, taking steps to stabilize the workforce and, in turn, develop a larger cadre of experienced staff.

OPM Pay Structure and/or Grade Level In some areas of the country, IRS has had difficulty hiring staff because of the low entry-level wage (i.e. GS-4) and because OPM certifications of applicants for government employment provided outdated information. To remedy this, IRS has obtained permission to (1) hire entry-level employees at the GS-5 level and (2) waive the OPM hiring procedures and advertise for positions under direct hire authority. Furthermore, in past years frontline assistors could only progress noncompetitively to the GS-6 level. Effective October 1987, frontline assistors can progress noncompetitively to the GS-7 level.

While these measures should make recruitment easier, we have no data to indicate how much of an improvement in accuracy, if any, would result.

Employee Training We have not studied training in depth but have monitored IRS' program in general. Local offices have frequently supplemented national office training materials and devised different methods of trying to improve performance. In addition, key guidance materials such as Publication 17, a standard explanation of the law widely used as a reference source by telephone assistors, were not available during much of the employee training for this filing season. Employee training is undoubtedly the single most important determinant in assistor accuracy. Therefore, assistor training is an issue that IRS needs to study to determine whether significant improvements to assistor accuracy are possible. Based on our test call survey and our on-site observations, areas where improvements appear possible are assistor probing and listening skills, and the provision of easy-to-use reference guides.

Production Standards and Quotas IRS monitors the work of assistors and has an overall service level goal (this year's goal is to answer 85 percent of the callers to its toll-free sites) but to our knowledge does not use production standards or quotas, such as number of calls answered or length of time to answer questions, as factors in personnel evaluations. We observed that assistors frequently performed lengthy research in order to answer taxpayers' calls, which would indicate that they were not subjected to production pressures.

Accuracy might also be enhanced through improvements to an assistor's work environment. Conditions under which assistors work are difficult and demanding. Space limitations force IRS to crowd assistors into relatively close quarters in large open areas with little privacy. Partitioned rather than open work areas could improve performance by removing distractions. Further, better reference materials, especially information that identifies key facts and/or probes needed to answer various questions, would also be helpful. Along those lines, the Automated Taxpayer Service System, a desk top computer-operated program of tax law information for assistors that is being tested in Dallas, may offer a means to improve accuracy.

We believe that IRS can make improvements in its telephone assistance program within the funding levels requested for fiscal year 1989. For example, improvements in IRS' training program would not necessarily require more money for more training but rather the use of available funds to provide better training. On the other hand, improvements in service quality that involve changing the mix and grades of seasonal, part-time, and full-time permanent employees and providing a better physical work environment would likely involve an increase in IRS' budget.

5. In your testimony you indicate that there are serious quality and accuracy problems in the area of IRS correspondence.

   a. Have you reached any conclusions as to why the quality of IRS correspondence is so poor?

   b. What is the impact of production quotas on quality in the area of correspondence?

   c. Have you reached any conclusions on the cost to taxpayers and to the IRS for correcting these errors?

   d. What can be done to improve the quality of correspondence?

   e. Do you believe approval of the FY 1989 budget request for Returns Processing will allow the IRS to significantly improve the quality of its correspondence?

GAO Response

No one factor appears to be solely responsible for the quality problems we identified in analyzing the correspondence generated by the Adjustments/Correspondence Branches in 3 of IRS' 10 service centers. Our review pointed to several contributing factors including (1) a need

for improved training and supervision, (2) the use of generic responses that make it difficult for service center tax examiners to compose an appropriate letter, and (3) a need for improved quality assurance. We also believe that IRS needs to evaluate the tax examiner position. As a minimum, that evaluation should include a reconsideration of production standards to ensure they are reasonable in light of the problems we identified. IRS might also consider whether the demands of the job and the potential impact on taxpayer relations warrant revision of the minimum requirements needed to qualify for a tax examiner position.

We do not have any specific dollar estimates as to the cost incurred by taxpayers and IRS as a result of the quality problems we identified. Some taxpayers were incorrectly assessed additional taxes and/or penalties but our review did not include a determination whether those incorrect assessments were eventually resolved. One major effect of poor quality correspondence is the amount of time and effort, on the part of IRS and the taxpayer, that can be expended in dealing with follow-up correspondence--correspondence that could have been avoided if IRS' initial response was appropriate. As an indication of that effect, about 22 percent of the 718 cases in our sample involved taxpayers who indicated that they had previous contacts with IRS regarding the same issue.

We do not know to what extent correction of the quality problems we identified will require additional resources. Many improvements may be possible within current funding levels. One solution, for example, may involve using available funds to provide better training rather than getting more money for more training. As we noted in our testimony, however, other solutions could require additional funds. If it is deemed unreasonable to expect relatively low-paid employees to deal with the complexities involved in answering taxpayer correspondence, the answer may lie in upgrading those positions which could require an increase in IRS' budget.

One of the program changes in IRS' fiscal year 1989 budget request involves 186 positions and $5.8 million to enable IRS to include more information on penalty and interest computations in the notices it sends taxpayers. Including that information in notices could preclude taxpayers having to write IRS for an explanation and thus reduce Adjustments/Correspondence Branch workload. As noted in our testimony, we support this initiative but have some reservations about IRS' contemplated approach. We believe it would be better for IRS to refocus this initiative toward implementing a system that will automatically include explanations on notices and require fewer manual computations.

6. How can the quality and productivity of IRS service center operations be improved? Are improved training courses and management guidelines needed?

GAO Response

We believe IRS can improve the quality and productivity of its service center operations by placing less emphasis on inspection and correction, and more on error prevention. IRS' inspection approach does little to prevent errors from recurring. Also, IRS' electronic filing initiative could positively affect the quality of returns processing. Other solutions may involve better training and more easily understood forms--which may not necessarily require additional funding. In addition, IRS' quality improvement project teams can have a significant effect on quality. At the national level, for example, IRS initiated a study of the Federal Tax Deposit System to identify and correct processing problems--such as mismatches between names and identification numbers on deposit coupons. Changes to this system (5.5 million business taxpayers make about 72 million deposits annually) can have a significant positive impact on the public. According to IRS, the changes identified and implemented through this quality improvement effort to date have reduced Federal Tax Deposit processing problems significantly.

Also, it is noteworthy that IRS has requested an increase for the Problem Resolution Program. If that increase is used to expand problem analysis as planned, it would be another step in the right direction toward minimizing recurring errors.

With respect to productivity, IRS' primary effort involves the Productivity Enhancement Fund. Created in 1981 and funded at $2 million dollars in fiscal year 1987, it allows for testing unique ideas which have the potential for improving productivity that would not normally be budgeted. In our opinion, Productivity Enhancement Fund projects, like the funding of an in-house industrial engineering management group for the Austin Service Center, have a great potential for positive increases in service center productivity. We believe, however, that this effort and the rest of IRS' Productivity Improvement Program should be folded into the quality improvement effort to enhance IRS' overall ability to improve both the productivity and quality of its service centers.

7. With regard to the importance of converting seasonal employees to permanent employees, the percentage of new hires has increased by 10% each year from 45% in 1985 to 65% last year.

a. Do you see that pattern continuing?

b. Did you study the cost-to-yield benefit ratio, due to increased efficiency, of a program to convert seasonal employees to permanent employees? If so, what are your findings?

GAO Response

According to IRS data, 65 percent of the total service center staff in fiscal year 1987 were seasonal employees. Of the seasonal employees, about 62 percent were new hires. This new-hire rate is slightly down from the fiscal year 1986 rate of 65 percent. IRS estimates that about 60 percent of its seasonal employees for fiscal year 1988 will be new hires. Thus, the percentage of newly-hired seasonal employees, although still high, has been declining. We have not compared the costs and benefits associated with a program to convert seasonal service center employees to permanent employees. Nevertheless, as we said in last year's testimony on IRS' fiscal year 1988 budget, IRS needs to pursue opportunities to stabilize the service center workforce. Without such stability, IRS will find itself using more and more of its limited resources to avoid and/or correct errors caused by inexperience.

GAO United States
General Accounting Office
Washington, D.C. 20548

Information Management and
Technology Division

B-231217

May 13, 1988

The Honorable J. J. Pickle
Chairman, Subcommittee on Oversight
Committee on Ways and Means
House of Representatives

Dear Mr. Chairman:

As you requested in your letter of April 18, 1988, we are providing you with information to complete the Subcommittee's April 13, 1988, hearing record on the Administration's fiscal year 1989 budget proposal for the Internal Revenue Service (IRS). Enclosed are responses to questions 8, 9, and 10 which address IRS' automated data processing and information technology resources. Our General Government Division is responding in a separate letter to those questions which address the Administration's budget proposal for IRS' taxpayer service, collections, and compliance activities (questions 1 through 7).

Question 8: In your testimony you point out that redesigning the tax processing system is critically important because IRS' automated data processing systems are outdated and inefficiently designed.

(a) Recognizing that IRS is still at a very preliminary stage in its Tax System Redesign project, is the IRS approaching this project in a proper, thorough, and systematic way?

Answer: IRS appears to be approaching the Tax System Redesign in a more thorough and systematic way than in the past. The current approach depends on the agency's staff, complemented by outside technical help. IRS has described the redesign as evolutionary, meaning that discrete improvements will be made incrementally to the current system until redesign objectives have been met. IRS has also identified preliminary design concepts. So far, these concepts appear reasonable; however, over the next couple of years, IRS plans to perform tasks critical to the redesign's success. IRS plans to define

user requirements, perform cost/benefit analyses for several different system design alternatives, and obtain approval from the General Services Administration and Department of the Treasury for acquisitions supporting the redesign. Completing these and other critical tasks should provide the basis for assessing the technical viability of the preliminary design concept, as well as the strategy, schedule, and costs for the program.

We will continue to assess IRS' strategy, plans, and actions to carry out its Tax System Redesign initiative and report our results to you.

(b) Does the Administration's proposed fiscal year 1989 budget provide a reasonable level of funding for the Service's Tax System Redesign efforts?

Answer: IRS' proposed fiscal year 1989 budget seems to provide a reasonable level of funding for Tax System Redesign efforts for fiscal year 1989. However, the estimated costs for future years may change significantly. First, the redesign is expected to take about 10 years to complete, cost several billion dollars and encompass numerous initiatives which will be implemented by an IRS-wide organizational effort. Second, IRS has not yet decided on a new design for the tax processing system. IRS cannot determine what the redesigned system will cost until it has identified alternative designs, conducted cost-benefit analyses, and selected a final design.

Question 9: At the Subcommittee on Oversight's February 23, 1988, hearing on the 1988 filing season, GAO continued to raise concerns about the ability of IRS service center computers to handle their projected work load in the 1992 to 1994 timeframe.

(a) Has the IRS supplied you with its proposals for meeting the service center computer "capacity gap?"

Answer: At the conclusion of the February 23, 1988, hearing IRS agreed to provide us with an analysis identifying weekend work load that can be either eliminated or deferred in order to extend the useful lives of its service center computers through 1994. On March 16, 1988, IRS provided us with a preliminary draft of that analysis, and on April 7, 1988, the final results.

(b) Have you had an opportunity to evaluate these proposed responses, and will they be effective?

Answer: We are assessing IRS' April 7, 1988, proposal for eliminating and deferring weekend processing work load to determine the proposal's reasonableness. In addition, we are assessing IRS' progress in implementing other capacity improvement initiatives that IRS has either planned or underway. These initiatives focus on improvements to the software used in processing tax returns and tax-return related information, distribution of the processing work load more evenly among the 10 service centers, and the procurement of dual UNISYS 1100/84 mainframe computers for all service centers. Based on our assessments, we plan to update our February 1988 projections using computer utilization data for the 1988 filing season. We will report our findings to you at the conclusion of our review.

Question 10: For the past several years, the Oversight Subcommittee has carefully monitored the progress of the IRS's efforts to replace front-end processors in its 10 service centers. Earlier this year, the new equipment was installed in the Fresno and Austin service centers.

(a) Is the equipment operating successfully in these first two locations?

The new front-end processors and terminals installed at the Fresno Service Center are operating successfully. At the Austin Service Center, however, system users are encountering long response times. IRS is attempting to

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determine whether the long response times are being caused by the new front-end processors or by the mainframe computers they support.

The problems being encountered at the Austin Service Center underscore the importance of the position we took in our October 1986 report[1] on the need to thoroughly test the new front-end processor system. We and IRS agreed that the system should be incrementally installed one service center at a time, working out any major problems before proceeding to the next service center. Thorough testing at each service center is essential to reduce the risk of disrupting service center operations. In addition, installing front-end processors one service center at a time gives IRS the opportunity to study the operating environment at each service center to determine the impact the new front-end processors have on such things as terminal response times and service center computer operations.

IRS has not formally accepted the new front-end processors installed at the National Computer Center (NCC) and the Fresno and Austin service centers because of unresolved problems with the software that supports the new equipment. IRS does not plan to formally accept the new front-end processors installed at its service centers until the front-end processors installed at NCC are formally accepted. According to IRS' May 2, 1988, Communication Replacement System Status Report, there are 13 software related problems that must be resolved before IRS will formally accept the NCC system. In addition to the problems at NCC, other problems may be identified as further acceptance testing and service center installations proceed.

(b) Is the IRS replacing the front-end processors at all the other service centers by January 1989?

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[1]Data Communication: Thorough Testing and Workload Analyses Needed for IRS Processors, GAO/IMTEC-87-3BR dated Oct. 14, 1986.

On the basis of the current Communications Replacement System project schedule, IRS' plan calls for completing nationwide installation and testing of the new front-end processors by January 1989. The following table shows IRS' timetable for completing the nationwide installation of the new front-end processors.

Current Milestones for Completing Communications Replacement System Acceptance Testing

| Order of Installation | Milestones as of May 2, 1983 |
|---|---|
| Fresno Service Center | Completed but not accepted |
| Austin Service Center | Completed but not accepted |
| Atlanta Service Center | 5/20/88 |
| Ogden Service Center | 7/23/88 |
| Memphis Service Center | 9/20/88 |
| Cincinnati Service Center | 10/03/88 |
| Philadelphia Service Center | 10/28/88 |
| Kansas City Service Center | 11/20/88 |
| Brookhaven Service Center | 12/15/88 |
| Andover Service Center | 1/07/89 |

We trust that this information will be helpful to your Subcommittee. If we can be of further assistance, please call me at 275-3455.

Sincerely yours,

James R. Watts
Associate Director

COMMITTEE ON WAYS AND MEANS

U.S. HOUSE OF REPRESENTATIVES
WASHINGTON, DC 20515

May 2, 1988

The Honorable Edward R. Roybal
Chairman, Subcommittee on Treasury,
Postal Service and General Government
Committee on Appropriations
U.S. House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

On April 13, 1988, the Subcommittee on Oversight of the Committee on Ways and Means held a hearing to examine the Administration's Fiscal Year 1989 budget proposals relating to the staffing and funding levels of the Internal Revenue Service (IRS) and the U.S. Tax Court. The following recommendations reflect our strong concern that: the FY 1989 IRS budget, despite its stated emphasis on quality service to Federal taxpayers, does not provide the resources necessary to remedy deficiencies in quality which have been identified by the Subcommittee; the proposed budget fails to provide funding for certain IRS initiatives that are necessary to advance the best interests of our voluntary Federal tax system; and, the budget does not account for certain other program activities essential to timely and appropriate administration of the IRS's responsibilities.

I. Taxpayer Service

A. Improve Taxpayer Service Accuracy:

During the Subcommittee's April hearing on the FY 1989 IRS budget, the Internal Revenue Service reported that 28 percent of the answers given to telephone inquiries were incorrect. At the same hearing, the General Accounting Office (GAO) reported that 38 percent of the answers were incorrect. Members of the Subcommittee and IRS Commissioner Gibbs share the belief that this is an unacceptably high error rate and must be improved next year. The Subcommittee concluded that there are two principal reasons for this high error rate.

The first reason for the IRS's high error rate in providing assistance and tax advice to taxpayers relates to their difficulty in retaining qualified workers. While the overall IRS attrition rate is 11 percent, the current attrition rate for seasonal Taxpayer Service Representatives is 40 percent. The Subcommittee believes there is a direct correlation between the inexperience of a large part of the current work force and the low quality of a significant portion of the tax advice and assistance provided to taxpayers. In a recent letter to the Subcommittee, the Commissioner indicated that one strategy for improvement in this area "is to develop a high quality work force." The Commissioner further explained, "In order to achieve this we intend to increase the ratio of permanent employees to temporary employees, and to provide incentives to stay with Taxpayer Service by increasing the grade structure."

We support the Commissioner's goal to improve the ability of the IRS to hire and retain qualified taxpayer service employees. Therefore, we recommend that resources for Taxpayer Service be increased by $6,588,000. This funding should be directed toward the conversion of 700 seasonal employees to permanent employees (at a cost of $2,100 per conversion) which would increase the percentage of permanent employees to 68 percent, from the current level of 53 percent; and, the upgrading of 1,000 Taxpayer Service Representatives to Taxpayer Service Specialists (at a cost of $5,118 per upgrade).

The second reason for the high error rates in IRS's taxpayer service relates to the inadequacy of IRS's employee training programs, both for new hires and current employees. The Commissioner has indicated to the Subcommittee that, due to budget submission deadlines, some of the improvements the IRS is making to the recruit training program "were not considered when developing the FY 1989 budget."

To ensure that IRS has the resources necessary to fully fund all training programs and improvements thereto, we recommend that resources for Taxpayer Service be increased by $5,000,000 and 350 positions. This funding should be directed toward the continuance of IRS improvements in employee training.

In total, we recommend that Taxpayer Service resources be increased by $11,588,000 and 350 positions, as described above.

B. Improve Service Center Handling of Taxpayer Correspondence:

At the Subcommittee's April hearing, the General Accounting Office presented testimony highlighting serious problems regarding the accuracy of the Internal Revenue Service responses to taxpayer correspondence handled in IRS service centers. The GAO recently reviewed 718 correspondence cases closed at three service centers. The resultant findings are alarming. In nearly 50 percent of the cases reviewed, the GAO found that the letter responding to the taxpayer's inquiry, the adjustment made to the taxpayer's account, and/or the action taken by the IRS as a result of the inquiry were incorrect, incomplete, unresponsive or unclear. In 30 percent of the cases reviewed, GAO considered the error critical since the service center incorrectly adjusted or failed to adjust the taxpayer's account, provided incorrect information, or failed to answer all of the taxpayer's questions. The problem is compounded since these errors necessitate additional correspondence between the IRS and taxpayers, and result in more errors and heightened taxpayer frustration.

In addition, this problem will be exacerbated by the FY 1989 correspondence initiative, proposed in the budget, which encourages taxpayers to write for penalty and interest explanations. The IRS expects that this new program will increase taxpayer correspondence by 3.4 million. The negative impact on both taxpayer confidence and service center operational costs resulting from the high error rate in correspondence processing cannot be overestimated.

We believe that this current and growing problem evidences the need for significant improvements in the training programs for new hires and current employees assigned to taxpayer correspondence. In addition, recent testimony by GAO indicated "improvements may be possible through better training and supervision." As noted above, improvements to IRS's training programs for new hires were not considered by the IRS when developing the FY 1989 budget.

Due to the fact that there are no resources provided in the proposed FY 1989 IRS budget to improve the quality of IRS's handling of service center correspondence, we recommend that resources for Returns Processing be increased by $6,144,000 and 202 positions. This funding should be directed toward improved training of both new hires and current employees.

C. Improve Reconciliation of Employee Earnings Records:

In September of 1987, the General Accounting Office issued a report discussing the long-standing operating problems that the Social Security Administration (SSA) and the Internal Revenue Service have had in reconciling reports of employee earnings made to the two agencies. The failure on the part of either agency to properly reconcile these employee earning records could result in reductions in Social Security benefits for certain workers. The GAO indicated that 60 percent of individuals with uncredited earnings faced the possible loss of Social Security benefits averaging $17 per month. In response to GAO's findings, the IRS and SSA have recently signed an agreement outlining each agency's responsibility in fully resolving this matter.

In order that the IRS has the resources to meet its obligations under this agreement, we recommend that resources be increased by $7,400,000 and 225 positions.

II. Compliance

There were a number of initiatives included in the Internal Revenue Service FY 1989 budget submission to the Department of the Treasury which were not included in the Administration's FY 1989 budget submission to the Congress. We call your attention to the IRS's proposed initiatives to enhance the examinations, information returns, delinquent returns compliance, and international compliance programs. We recommend that the Committee on Appropriations carefully review the purpose and goal of these initiatives and fund them accordingly. We believe the highest priority should be given to implementing the final installment of the Examination Revenue Initiative.

A. Examination Revenue Initiative:

The third and final year of the FY 1987-1989 Examination Revenue Initiative is part of a three-year Administration program to improve tax compliance and to close the tax gap. The final installment of the initiative was not included in the Administration's FY 1989 budget submission to the Congress. Testimony received from the General Accounting Office emphasized the importance of hiring additional examination staff to reverse the continuing downward trend in examination coverage rates. We believe the goals of this initiative, to improve tax compliance and to insure an appropriate level of examination coverage, remain critically important.

Further, in the past few years, budget submissions to the Congress continue to show an important discrepancy in the percentage of returns projected to be examined by the Internal Revenue Service and the actual percentage of examinations achieved in those years. In FY 1988, for example, the audit rate achieved was a .4 percent below budget projections. We are concerned, therefore, that the FY 1989 projected examination coverage of 1.27 percent may prove equally optimistic. If projected versus actual examinations differ as in the past, the result will be an actual examination rate for FY 1989 of less than one percent. This would be an all-time low.

According to a recent IRS projection, funding of the final installment of the Examination Revenue Initiative in FY 1989 will raise the examination rate to 1.32 percent and allow for examination of 66,000 additional returns. We believe the value of examination coverage in ensuring tax compliance dictates funding of the third year of the initiative.

In a January 1988 appeal letter to the Department of the Treasury, IRS Commissioner Gibbs strongly appealed to the Administration for inclusion of the final installment of the Examination Revenue Initiative in the FY 1989 budget. The Commissioner indicated that the failure of the Office of Management and Budget (OMB) to fund new revenue initiatives in FY 1989, including the Examination Revenue Initiative, "limits staffing in the Examination program to the extent that we do not believe the budget summit revenue yield of $2.9 billion in 1989 could be met."

According to testimony received by the Subcommittee from the Commissioner, the appeal was denied because the Bipartisan Budget Summit Agreement did not call for additional revenue. When questioned regarding the potential shortfall in revenue, the Commissioner indicated that the IRS has been exceeding revenue estimates over the last several years and now believes they will achieve the budget summit revenue yield.

We believe administration of the tax laws requires meaningful examination coverage by the IRS to ensure taxpayer compliance. In addition, we are not comfortable with the OMB posture that examination resources are no longer necessary when, only three months ago, the Commissioner believed they were essential. Our analysis shows that implementation of the Examination Revenue Initiative would require that resources be increased by $147,700,000 and 3,302 staffing positions (2,500 revenue agents plus support staff).

B. Information Returns Program Initiative:

The Information Returns Program is designed to identify taxpayers who have not filed individual income tax returns and to secure such returns through correspondence and field contacts. On March 17, 1988, the Subcommittee held a hearing to review the Internal Revenue Service's 1988 report on income tax compliance and the estimated "tax gap." (The tax gap is generally considered the amount of money owed in Federal income taxes but not voluntarily paid by individuals or corporations in a year.) At that hearing, the IRS reported that the 1987 tax gap of $88.9 billion is expected to reach $119 billion by 1992. Almost one-tenth of the ever-increasing tax gap is attributable to nonfilers. One strategy to cope with this problem is to increase the IRS's capability to detect noncompliance by nonfilers. The IRS's Information Returns Program Initiative is not included in the Administration's FY 1989 budget submission to the Congress. Funding of the Initiative would improve the IRS's ability to detect noncompliance and would enable IRS to secure 200,000 additional delinquent tax returns.

Our analysis shows that implementation of the Information Returns Program Initiative would require that resources be increased by $7,800,000 and 184 positions.

C. Delinquent Returns Compliance Initiative:

The objectives of the Delinquent Returns Compliance Initiative are: to examine employment tax returns; to investigate the use of offshore money laundering; and, to conclude an increased number of Business Master File delinquent return investigations. The Internal Revenue Service's Delinquent Returns Compliance Initiative is not included in the Administration's FY 1989 budget submission to the Congress. It is important that the IRS be able to undertake their obligations in these important areas.

Our analysis shows that implementation of the Delinquent Returns Compliance Initiative would require that resources be increased by $42,800,000 and 1,088 positions.

D. International Compliance Initiatives:

The objectives of the International Compliance Initiatives are: to improve the effectiveness and efficiency of processing tax returns and foreign information returns; to conduct operational studies of U.S. taxpayers overseas; to increase the number of special agents to develop cases on money laundering, drug smuggling and offshore banking; to

increase examination coverage of high-income individual returns, large-case corporation returns, and foreign corporation returns; and, to increase collection efforts focusing on U.S. taxpayers abroad. The Internal Revenue Service's International Compliance Initiative is not included in the Administration's FY 1989 budget submission to the Congress. We conclude that more resources should be devoted toward international enforcement.

Our analysis shows that implementation of the International Compliance Initiative would require that resources be increased by $6,600,000 and 116 positions. In addition, we strongly support the additional funding provided in the FY 1989 budget to improve the assistance given to U.S. taxpayers overseas.

In total, these four initiatives will result in additional revenues of $.77 billion in FY 1989 and $1.68 billion in FY 1990.

III. Office of Chief Counsel

Finally, we call your attention to a potential inadequacy in the proposed staffing and funding levels of both the Appeals and Tax Litigation function and the Enforcement Litigation and Technical function, in the Office of Chief Counsel. Attorneys in both of these areas are instrumental in the interpretation and implementation of the Tax Reform Act of 1986. These Internal Revenue Service functions provide legal advice and assistance to the IRS field offices and taxpayers.

The IRS FY 1989 budget submission to the Department of the Treasury requested 662 additional positions for Appeals and Tax Litigation. The Administration's FY 1989 budget submission to the Congress provides for only two additional positions for this function, despite estimates that the docketed Tax Court and refund case receipts will increase by nearly 6,000 cases and the docketed ending inventory will increase by 12,700 cases. Also, the IRS budget submission requested 91 additional positions in FY 1989 for the Enforcement Litigation and Technical function. The Administration's FY 1989 budget proposes a decrease of four positions from the FY 1988 level, even though enforcement litigation and technical case receipts are expected to increase by 2,400.

Although the proposed budget does not substantially decrease staffing levels for these functions, we are concerned that failure to increase staffing levels will result in increased inventory levels and have an adverse affect on tax reform implementation, employee recruitment, and employee retention.

IV. Conclusion

In total, we recommend the Administration's Fiscal Year 1989 budget proposal relating to the Internal Revenue Service be increased by 777 positions and $25,132,000. Furthermore, we are hopeful you will give careful attention to our concerns relating to the Administration's failure to provide funding in the proposed FY 1989 budget for the aforementioned IRS compliance intiatives.

Attached are the materials, prepared by the IRS, which were used in development of our analysis. In addition, we have requested and expect to soon receive written materials from the IRS which provide more detailed analyses of the information used in developing our recommendations. A copy of this correspondence will be forwarded to you immediately upon receipt.

As in the past, we appreciate working with you to ensure the Internal Revenue Service has the necessary resources to fairly and effectively administer our Federal tax laws.

Sincerely yours,

Dan Rostenkowski, Chairman
Committee on Ways and Means

J. J. Pickle, Chairman
Subcommittee on Oversight

Attachments

cc: The Honorable John J. Duncan, Ranking Minority Member
Committee on Ways and Means

The Honorable Richard T. Schulze, Ranking Minority Member
Subcommittee on Oversight

The Honorable Joe Skeen, Ranking Minority Member
Subcommittee on Treasury, Postal Service and General Government

The Honorable Jamie L. Whitten, Chairman
Committee on Appropriations

The Honorable Silvio O. Conte, Ranking Minority Member
Committee on Appropriations

The Honorable William H. Gray III, Chairman
Committee on the Budget

The Honorable Delbert L. Latta, Ranking Minority Member
Committee on the Budget

IRS SUBMISSION TO THE OVERSIGHT SUBCOMMITTEE

ALLOCATION OF ADDITIONAL STAFFING
OVER FY 1988 LEVELS

Question 2: How would the Service allocate additional staffing over the proposed FY 1988 levels at each of the following levels?

a) 500 additional staff?
b) 1,500 additional staff?
c) 3,500 additional staff?
d) 5,000 additional staff?
e) What would the yield-to-cost ratio be at each level?

Answer: The President's budget, which was submitted on February 18, 1988, includes additional resources (1,650 positions and $241 million) for the Internal Revenue Service to:

-- resolve taxpayer problems (46 positions),
-- improve the quality of taxpayer correspondence (information on penalty and interest computations) issued by IRS service centers (186 positions),
-- expand efforts to detect tax fraud (127 positions), and
-- continue ADP and systems modernization efforts (758 positions),
-- handle additional tax returns resulting from growth in the taxpaying populations (489 positions net after productivity and other savings).

These resources are critical to IRS operations and represent our first priority.

In keeping with the emphasis on service and quality, our next priority is to finance those activities which serve the public. We are assessing our performance during the current filing season to determine whether resources are adequate to reach those goals. We will have to advise the Administration on this assessment. In the interim, any allocation of additional staffing beyond the President's budget represents IRS's position, not the Administration's view.

In the area of revenue-producing programs, with additional resources we would fund the third installment of the FY 1987 - FY 1989 Examination revenue initiative (3,302 positions at a cost of $147.7 million). This would further our goal of increasing audit coverage, producing additional revenue ($347 million in FY 1989; $858 million in FY 1990), and promoting voluntary compliance. It would have a revenue impact greater than the direct revenue quantified here due to the indirect compliance effects of increased audits.

We would also increase staffing in the Information Return program to help us identify those people not filing tax returns (184 average positions, $7.8 million), the Accounts Receivable program to collect taxes owed but paid (426 average positions, $17.8 million), and the Deliquent Returns program (1,088 average positions, $42.8 million). These initiatives, along with the Examination initiative, would produce additional FY 1989 revenue of $822 million and additional FY 1990 revenue of $1,773 million. Incremental levels are shown on the attached chart.

INTERNAL REVENUE SERVICE
DIRECT REVENUE PRODUCING ENFORCEMENT PROGRAMS
(Dollars in Millions)

| LEVEL OF INCREASE | AVG. POS. | COST | FY 1989 REVENUE | FY 1989 YIELD/COST | FY 1990 REVENUE | FY 1990 YIELD/COS |
|---|---|---|---|---|---|---|
| A. Examine tax returns | 529 | $23.6 | $69 | 2.9 to 1 | $172 | 7.3 to 1 |
| B. Examine tax returns | 1,321 | 59.0 | 162 | 2.8 to 1 | 402 | 6.8 to 1 |
| C. Examine tax returns * | 3,302 | 147.7 | 347 | 2.3 to 1 | 858 | 5.8 to 1 |
| Match IRP information documents * | 184 | 7.8 | 88 | 11.3 to 1 | 126 | 16.2 to 1 |
| Total, Level C | 3,486 | $155.5 | $435 | 2.8 to 1 | $984 | 6.3 to 1 |
| D. Examine tax returns * | 3,302 | 147.7 | 347 | 2.3 to 1 | 858 | 5.8 to 1 |
| Match IRP information documents | 184 | 7.8 | 88 | 11.3 to 1 | 126 | 16.2 to 1 |
| Collect taxes owed but not paid * | 426 | 17.8 | 75 | 4.2 to 1 | 125 | 7.0 to 1 |
| Secure delinquent returns * | 1,088 | 42.8 | 312 | 7.3 to 1 | 664 | 15.5 to 1 |
| Total, Level D | 5,000 | $216.1 | $822 | 3.8 to 1 | $1,773 | 8.2 TO 1 |

IRS SUBMISSION FOR THE RECORD TO THE SENATE COMMITTEE ON APPROPRIATIONS, SUBCOMMITTEE ON TREASURY, POSTAL SERVICE AND GENERAL GOVERNMENT

INTERNAL REVENUE SERVICE

FY 1989 Revenue Initiatives
Dollars in Millions

| Initiative | Ave. Pos. | Amount | FY 1989 Revenue | FY 1990 Revenue |
|---|---|---|---|---|
| Exam. Revenue Initiative * | 3,302 | $147.7 | $347 | $858 |
| Exam. Service Center TE Initiative | 634 | 14.4 | 134 | 155 |
| Information Returns Initiative * | 184 | 7.8 | 86 | 126 |
| Collection TDI Initiative * | 2,018 | 86.3 | 408 | 869 |
| Collection TDA Initiative | 533 | 22.3 | 94 | 157 |
| Returns Processing DATC | 55 | 1.5 | 19 | 23 |
| International * | 116 | 6.6 | 30 | 34 |
| TOTAL | 6,842 | $286.6 | $1,120 | $2,222 |

— LETTERS FROM THE IRS APPEALING OMB'S BUDGET —

DEPARTMENT OF THE TREASURY
WASHINGTON

JAN 7 1988

ACTION

FOR: THE DEPUTY SECRETARY

FROM: Lawrence B. Gibbs
Commissioner of Internal Revenue

SUBJECT: Appeal of OMB Action on IRS Budget

I have reviewed OMB's action on our 1988 budget and 1989 budget request. The OMB passback in many ways recognizes and deals with the important issues facing tax administration. I am pleased with OMB's recognition of the need to provide proper funding to the tax processing and taxpayer service activities, particularly in view of the sweeping changes that tax reform brings. I fully support OMB's proposal to apply excess FERS funds to meet the taxpayer service need of $58 million in 1988 and to establish this funding as part of the taxpayer service base for 1989. Similarly, the allowance provides for a properly funded tax processing operation in 1988 and 1989. This is a critically important and most welcome aspect of the allowance. However, there are some significant concerns I need to bring to your attention which must be resolved.

NOTE * Revenue Producing Efforts

Our FY 1989 budget proposed to continue many of the initiatives begun during the past two years and add new initiatives to collect more tax revenue. These initiatives would produce over $1 billion in additional tax revenue. It makes sense to provide IRS with funding to collect taxes already on the books that are not being paid instead of penalizing those who are already paying their fair share. The OMB allowance funds no new revenue initiatives in 1989, including the third and final installment of the Examination revenue initiative.

| | INITIATOR | REVIEWER | REVIEWER | REVIEWER | REVIEWER | SECRETA |
|---|---|---|---|---|---|---|
| OFFICE CODE SURNAME | Taylor | Walsh | Murphy | | | |
| INITIALS/DATE | 1/7 | 1/7 | 1/7 | / | / | / |

THE DEPUTY SECRETARY

The allowance limits staffing in the Examination program to the extent that we do not believe the budget summit revenue yield of $2.9 billion in 1989 could be met. We will need some 1,100 additional Examination FTE and $45 million to secure $415 million additional revenue needed to achieve the target.

Congress, in the Omnibus Budget Reconciliation Act of 1987 stated that "outlays for the IRS for fiscal year 1989 should be increased by $.7 billion and for fiscal year 1990 by $.8 billion... (and that) the IRS should offer improved taxpayer assistance and enforcement efforts." We believe that the Administration's budget proposal should give effect to this legislation.

OMB has also proposed that an additional $2.4 billion in revenue be scored without funding. OMB's expectations cannot realistically be met.

ADP Modernization

Our request for additional ADP and systems modernization was aimed at sustaining ongoing ADP projects such as the automation of the examination system as well as some new projects. OMB has provided the requested increases for most projects, but has either drastically cut or eliminated increases to the Counsel Automated Tracking System, Field Automation Support, Integrated Management System, and the Automated Examination System. The Counsel Automated Tracking System would provide automation tools for employees at a cost benefit ratio of more than 20 to 1, closing an additional 1,000 cases and acelerating revenue collections by $210 million in the first year of systems implementation. We are also concerned over the elimination of our nationwide office automation funding.

THE DEPUTY SECRETARY

Mandatory Increases

OMB has denied mandatory costs increases for within-grade step increases ($16.7 million), advancement of trainees ($14.3 million) and other salary deficits ($2.9 million). IRS traditionally discounts its budget for the delay in hiring and promoting employees and for filling vacancies at lower rates of pay than incumbent levels. OMB has not taken this into account.

Full absorption of this reduction would result in a loss of 1,000 jobs and $170 million in revenue collections as a majority of the cost increases occur in tax enforcement staffing.

Technical Adjustment

OMB did not provide sufficient FTE for the level of operations funded in the allowance. An adjustment of +1,286 FTE must be made to correct this.

Tax Processing: Out Years

I am concerned that staffing increases for the service centers may not be provided beyond FY 1989. We are pursuing automation initiatives such as electronic filing which we expect will reduce certain labor-intensive functions. It is, however, premature to foreclose any staffing increases at this time.

NOTE ON TAX COURT

Privatization

I have several concerns with the privatization proposal raised by OMB. Any private dispute resolution mechanism available to only those who can afford the additional costs could undermine the credibility of our

THE DEPUTY SECRETARY

tax administration processes. The Service cannot develop regulations without the benefit of the numerous legislative changes that this proposal would require. The adoption of such a proposal without careful consideration of all of the policy ramifications, and the necessary advance consultation with the Tax Court, the Tax Bar, the professional accountants, the Justice Department and others, will result in a proposal that is neither workable nor desirable for the taxpaying public.

* Summary

We are providing detailed information in the format prescribed. In summary, we propose that you appeal 8,209 FTE and $365 million. This will result in more equitable tax administration and increase direct enforcement revenues by $1.4 billion. I will be available at your convenience to discuss with you any specifics of our appeal.

Attachments

DEPARTMENT OF THE TREASURY
WASHINGTON

JAN 22 1988

FOR: THE DEPUTY SECRETARY

FROM: Lawrence B. Gibbs
Commissioner of Internal Revenue

SUBJECT: Examination Revenue Initiative

NOTE: I am concerned about the intention of the Office of Management and Budget to exclude the third and final installment of the Examination Revenue Initiative from the President's proposed budget for FY 1989. This would seriously undermine the Administration's credibility.

The Examination Revenue Initiative has been cited in the President's budget since 1986. In the FY 1986 budget, the initiative was described as follows:

> In 1986 the Internal Revenue Service will begin initial phases of an initiative to close the gap between taxes owed and paid, and to improve overall compliance with the tax laws. Based on a Grace Commission (President's Private Sector Survey on Cost Control) recommendation, examination staffing will be increased by 2,500 full-time equivalent personnel in each year, 1987-89. Advance hiring will begin in 1986. Receipts are estimated to increase by $8.5 billion in 1987 and $1.5 billion in 1988 as a result of this initiative.

In testimony before the House Subcommittee on Appropriations last spring, Secretary Baker said that "our second objective is to strengthen the capability of the IRS to promote tax compliance and generate revenue. In FY 1988, we are requesting funds for the second of a major revenue initiative begun in FY 1987." Later, in the same hearing, he stated:

> The IRS budget also funds the second phase of the FY 1987-1989 Examination Revenue Initiative, which will permit the IRS to collect an additional $443 million in FY 1988 and $5.9 billion by FY 1992.

| | INITIATOR | REVIEWER | REVIEWER | REVIEWER | REVIEWER | SECRETAI |
|---|---|---|---|---|---|---|
| OFFICE CODE / SURNAME | C:PR Bedick | | | | | |
| INITIALS / DATE | 1-22-88 | / | / | / | / | / |

THE DEPUTY SECRETARY

Former Commissioner Egger and I have referred to the Examination Revenue Initiative in each appearance made before the Senate and House Appropriation Subcommittees during the last three years. In his remarks regarding the FY 1987 budget, former Commissioner Egger noted that "the cornerstone of the budget is a major revenue initiative. The proposal calls for annual increments of 2,500 examination staff for three years, beginning in fiscal year 1987." It is my recollection, that Director Miller also testified on behalf of a three year initiative to examine more tax returns.

I appreciate your support of this initiative. I am available to assist you in obtaining Administration support.

## Submissions for the Record

### Statement of Charles W. Hall on Behalf of the American Bar Association

I submit this testimony today at the request of Robert MacCrate, President of the American Bar Association, with respect to the Administration's proposed fiscal year 1989 appropriations to the Internal Revenue Service. The 30,000 members of the Section of Taxation of the American Bar Association have all been concerned with the efficient and effective operation of the IRS and we are pleased to present this testimony on behalf of the 300,000 members of the American Bar Association.

This testimony does not attempt to address specific line items of the IRS budget. We are, instead, addressing what we perceive to be major resource and structural problems within the IRS budget and the outside constraints on its operations and suggesting approaches to deal with these issues.

Summary

In its fiscal year 1989 budget, the IRS is requesting an increase of 1,650 positions and an additional $244 million. This is a 4.8% increase over its 1988 budget. We understand that this request is in general conformity with the budget reconciliation agreement reached in December of 1987. A large share of this increase is to be used to support the ever increasing tax processing operations and continuation of the modernization of the computerized information system.

We agree completely that these two areas are so essential and basic to the tax system that they should receive priority to the call for funds. However, as we have indicated in previous years in testifying about the IRS' budget, we recommend that the Revenue Service must have a balanced program, including examination, appeals, collection, and taxpayer service. We have also recommended in prior testimony before this committee that the IRS Commissioner obtain the authority which was given last year to reallocate appropriations among the budgetary categories to the extent of 4%. With the major changes to the tax system brought about by the Tax Reform Act of 1986 as well as those included in the Omnibus Reconciliation Act of 1987 such transfer authority, we believe, has enabled the IRS to better meet the challenges presented. Until there is some stability in the tax law, we believe it is essential to have authority to "plug the holes in the dike" as they arise.

Substantial Progress for 1986 and 1987

We believe the Service should be commended for the substantial progress it has made in the last two years in carrying out its objective of better administering the income tax laws. This would not have been possible without the additional funding provided by Congress in the last three budget years. It has been established that there is a strong nexus between the budget of the IRS and the amount of taxes collected. There is much yet to be done over the next several years to bring IRS operations where they should be. The Tax Reform Act for 1986 was designed to instill more fairness in the tax system and to restore much of the lost credibility that the system had suffered through in prior years. However, we do not believe that rewriting the tax code alone is enough. It is equally if not more important that the tax law be administered in such a way that taxpayers will believe that they are being fairly treated and are not being required to pay more than their share.

Tax Reform Act of 1986

It is too early yet to evaluate how well IRS has done in implementing the Tax Reform Act of 1986 for the 1988 filing season. Such implementation was and is a tremendous job. We do, however, wish to commend IRS for the innovative actions it has taken to alert the public to the changes that will affect their 1987 tax liabilities. The Service has emulated its publication program so that the provisions of the Act that will affect most of the taxpayers have been explained. Notices, announcements, and news releases have been employed to a greater extent to disseminate information to the public. Taxpayer service has been expanded to answer the great increase in the number of questions raised by the significant changes in the tax law. Yet not nearly all the questions generated by that act have been answered and there should be no let up in the preparation and dissemination of required interpretative material. There is an attitude on the part of some taxpayers that even if they wished to file a correct return, the new law is so different and so hard to understand they wouldn't be able to and therefore they're not even going to try. Much of the news coverage of the tax filing season has tended to confirm this notion on the part of taxpayers. If such an attitude became pervasive, the self assessment system would be severely eroded. We commend the Commissioner and the IRS for the helpful and understanding attitude which they have taken towards taxpayers trying to file correct 1987 returns. They foresaw at an early stage the difficulty that taxpayers might experience and planned well to disseminate the essential information to the public to beef up taxpayer service and to enlarge the volunteer taxpayer assistance program. Their actions as well as their pronouncements have displayed an attitude of understanding of the problems that taxpayers are facing.

Long-term Computer Program

We Would like to reaffirm strong support of the Service's long-term computer project looking towards a new, up-to-date computer system for 1995. The IRS computer system for a number of years could best be described as make-shift. We would not presume to know the type system that is needed for IRS, but we are convinced that an efficient administration of a tax system which involves so many people and so many items and so many documents and so many bits of information that can be accurately attributed to each individual taxpayer will require a much improved and updated system. Almost as essential as a fair tax law that the taxpayer can understand is a tax administration system that is prompt and accurate and understandable. Unless taxpayers are convinced that the IRS has a good handle on the processing of returns and other documents, it may lose respect for the other activities of IRS. We strongly recommend that the Congress make available to IRS the funds necessary to complete its computer update by the time planned.

Biennial Budgets and Separate Treasury Appropriations

We reaffirm our strong recommendation of prior years that the Congress consider a biennial budget for the Internal Revenue Service. The last time the Internal Revenue Service consistently had an approved budget in place prior to the start of a fiscal year was 1976. The process has deteriorated since that time and since 1980 the IRS has "functioned" on the basis of continuing resolutions. It is difficult to condone

operating without a budget. The failure of Congress and the President to produce timely budgets fosters inefficiency, uncertainty, and lack of accountability among those responsible for achieving tax compliance goals and objectives.

The Internal Revenue Service is particularly affected by the inefficiency resulted from perennial delay in the annual budget cycle. The Service's budget is largely devoted to nondiscretionary spending. Returns must be processed, documents must be matched, examinations must be commenced, taxes must be collected. All of these activities must be carried out on a timely fashion within prescribed limits. Failure to take timely action may cause much greater loss later either in the form of costly corrective action or in permanently foregoing revenue. It is not possible to plan effectively or to train and utilize personnel effectively or to institute any desirable long range programs until the budget is in place. The design and updating of the computer system is one particular area that just cannot be reasonably handled under last minute continuing resolutions. If the Congress has any interest in giving the biennial budget idea a trial we would suggest that perhaps Internal Revenue Service might be a place to start.

In conclusion, we strongly applaud the Congress for the steps that have been taken in recent years to improve the funding for the IRS. We would also like to applaud the Commissioner and the thousands of employees of the Internal Revenue Service who over the years have been carrying out probably the most important governmental function effectively, efficiently and with professionalism and dedication to the public service generally with too limited resources.

Thank you for this opportunity to present these views on behalf of the American Bar Association. The ABA and its Section of Taxation stand ready to provide any assistance within our capabilities to you in your consideration of these important subjects.

0031A

STATEMENT OF ROBERT M. TOBIAS, NATIONAL PRESIDENT
NATIONAL TREASURY EMPLOYEES UNION

Mr. Chairman and Members of the Subcommittee:

I am Robert M. Tobias, National President of the National Treasury Employees Union. NTEU is the exclusive representative of over 120,000 Federal workers, including virtually all employees of the Internal Revenue Service. I am accompanied today by Patrick Smith, NTEU Director of Legislation, and Paul Suplizio, legislative consultant.

On behalf of the men and women who collect the revenue of the Federal government, I am pleased to appear before you to present our recommendations on Internal Revenue Service appropriations for FY 1989.

Administration's Proposed Budget

The Administration's budget request for IRS calls for an increase of 1,650 average positions and $240 million in FY 1989, thus continuing the improvements begun three years ago to stem the fall in voluntary compliance (Table 1). Our tax administration system has been steadily strengthened since 1983, with positions in Returns Processing, Examination, Appeals, Collection, and Taxpayer Service all rising significantly (Tables 2 and 3). IRS is now implementing a major overhaul of our tax laws that will affect every citizen, so we are fortunate to have the resources that have been added in recent years.

During the past two years, 4,300 positions were added to Examination as part of a successful revenue initiative that raised audit coverage and brought in $1.2 billion. While we regret the Administration's decision not to go forward with the planned addition of 2,500 more positions this year, we believe the budget request is responsive to most of the priority needs of the Service and should be viewed as a minimum requirement. It should also be noted that this budget is $700 million and 8,900 average positions less than what IRS requested from OMB. Under this budget, most IRS performance indicators will either rise moderately or hold steady (Table 4).

Voluntary Compliance Tax Gap

Whether or not any IRS budget can be considered adequate depends on two factors: the state of voluntary compliance and the government's revenue needs. IRS has provided fresh evidence on the state of voluntary compliance in its recent study of the tax gap, which it estimates at $87 billion this year and projects to be $113.7 billion in 1992. According to GAO's review of this study, an important assumption made by IRS in projecting the tax gap to future years was that the compliance rates for various types of income remain constant instead of continuing to decline. IRS based this assumption on the effects of congressional actions which have loweredmarginal rates, curbed tax shelters, and provided new tools to strengthen compliance.

Certainly there is something to be said for this logic. But is it realistic to assume that today, after two decades of decline, voluntary compliance has stopped falling? Tax Reform is just beginning to take hold, and we have little evidence of its effects on taxpayers. Nevertheless, IRS shows the compliance rate rising from 81.1 percent in 1986 to 84.2 percent in 1992. We hope this optimism will be borne out, but more likely it will prove

premature. We believe several more years of strengthening enforcement and taxpayer services are required before we will see a turnaround in compliance.

We now have a hidden tax gap of $55 billion in delinquent accounts receivable that is not even included in the measured tax gap, but has grown 60 percent in the past three years and is seriously eroding the flow of revenues to the Federal government. This is a serious problem that Congress needs to address as soon as possible in line with the recommendations we are making today.

In its study of the underground economy in 1984, the Commerce Department's Bureau of Economic Analysis showed that unreported income was growing at 14 percent a year, significantly faster than the general economy. In IRS' current study, the tax gap grows at 7 percent a year, in line with the projected growth of GNP. IRS is telling us not only that compliance has stopped falling, but also that the underground economy -- unreported transactions that account for most of the tax gap -- has stopped growing relative to GNP. This would imply that we are getting the tax gap under control. We believe there is little evidence to support such a conclusion at this time.

Federal Revenue Needs Dictate Strengthening IRS

Responding to the extraordinary drug problem that now confronts the nation, legislation has been introduced in both the Senate and House embodying a comprehensive anti-drug abuse program that addresses both the supply and demand sides of narcotics control. These bills authorize an additional $2.4, billion over and above the President's program, for interdiction, eradication, education, treatment, and criminal justice in FY 1989. The revenue required to fund such a program, to reduce the Federal deficit, or for any other worthwhile purpose, could be obtained by further strengthening our tax system.

In order to raise the funds needed to seriously attack the drug problem, the Senate bill authorizes 6,842 additional IRS positions in Examination, Collection, Returns Processing, and Taxpayer Service. IRS has testified that these positions would cost $286 million and yield additional revenue of $1.12 billion in FY 1989 and $2.22 billion in FY 1990.

The 66 senators who are sponsoring this legislation evidently agree that present IRS compliance activities have a high yield-to-cost ratio, so that relatively small increments of resources will yield large revenues. At current levels, so few returns are being examined, delinquent accounts are being worked, and underreporter notices are being sent, that significant revenues legally owed the Federal government are not being obtained.

NTEU supports this legislation not only because of the urgent national need it embodies, but because our tax system still has serious problems and requires further strengthening. A glance at Table 4 shows serious inadequacies in IRS performance. Audit coverage stands at 1.2 percent, whereas 2 percent or more should be the norm to deter non-compliance and put an end to the audit lottery. The accounts receivable inventory remains at an all-time high, while revenue in delinquent accounts has reached an astronomical $55 billion.

A newly-emerging component of our compliance problem is $3.7 billion in delinquent payroll taxes, up 49 percent since 1982. Compliance with international tax rules is another area of noncompliance. An IRS survey of 12,000 foreign-owned companies found they were paying an average tax of about 1 percent on their U.S. operations; a substantial number of those companies are paying no U.S. tax at all. Overseas tax havens need to be brought into compliance. So do U.S. corporations who are underreporting interest and dividend income, costing the Treasury an estimated $8 billion a year.

In Taxpayer Service, IRS should assist more, not fewer, taxpayers to promote compliance with the new Tax Reform Act, and should do so with higher standards of accuracy and timeliness. These examples demonstrate that the struggle to put our tax system on a sound footing is far from over.

Establish a Ninety Percent Compliance Objective

NTEU has long urged that Congress establish a 90 percent voluntary compliance level as a national objective. This objective would set the standard against which steps to strengthen the tax administration system would be measured. Voluntary compliance plummeted from 90 percent in the late sixties to near 80 percent today, a situation resulting from two decades of economic change. It is imperative that the measures Congress has only begun taking to restore the situation continue until the 90 percent goal is achieved.

In its Five Year Resource Plan, FY 1988-FY1992, IRS spelled out how it would allocate 9,457 average positions over five years to raise voluntary compliance. Additional resources would go to improve taxpayer service, provide taxpayers more tax account and returns processing information, increase tax fraud investigations, strengthen international tax administration, investigate overseas tax havens, match business information documents, and increase Examination and Collection by 8,600 average positions. This program would increase audit coverage to 2 percent and generate additional revenue of $6.3 billion.

In this plan, IRS provides a blueprint for moving toward 90 percent voluntary compliance while generating significant revenue for deficit reduction and other national purposes. NTEU's recommendation of 6,800 additional positions for IRS in FY 1989 is in line with the concepts of this plan. IRS has stated that it can absorb up to 12,000 new positions a year, so the proposed expansion is feasible.

NTEU Recommended Appropriation for FY 1989

The President's budget request for FY 1989 and NTEU's recommendation are shown in Table 5. We recommend an additional $4.6 million and 186 average positions for the document matching program in Returns Processing, generating additional revenue from more non-filer and underreporter notices.

NTEU recommends an additional $159 million and 3,800 average positions for Examination and Appeals. This recommendation essentially restores the 7,500 position revenue initiative originally put forward by the

Administration. To date, 4,300 average positions have been allocated, so an additional 3,800 positions will complete the program and provide 600 more Appeals Officers to deal with backlog of cases in Appeals.

NTEU recommends an additional $123 million and 2,800 average positions for Investigation, Collection, and Taxpayer Service. The yield-cost ratio in Collection is one of the highest in IRS, 17 to 1, and our recommendation is prompted by the rapidly growing backlog of accounts receivable and increasing amount of revenue in these accounts. A 2,000-position revenue initiative for Collection is an urgent requirement to reduce this backlog and speed up the flow of monies to the Treasury. In addition, 800 positions would be allocated to Taxpayer Service to improve both accuracy and timeliness of telephone assistance, and to assist more taxpayers.

In sum, NTEU recommends $5,586,338,000 and 120,653 average positions for IRS in FY 1989. This is $286,613,000 and 6,842 average positions above the President's budget request.

Examination

The Examination Division is the backbone of IRS' efforts to achieve a high degree of voluntary compliance with the tax laws. Between 1976 and 1987, noncompliance grew while audit coverage fell from 2.6 to 1.1 percent. There is little doubt that IRS is now conducting far too few face-to-face audits. There are many issues, particularly those associated with underreported income and questionable deductions, that can be resolved only by meeting with the taxpayer. The taxpayer will frequently discuss the audit with his friends and associates, and he may take greater care in his future filings.

Looked at by type of return, present audit coverage of 1.2 percent in FY 1988 reveals many inadequacies, such as 1.3 percent coverage for individuals, 1.1 percent for small corporations (under $500,000 total assets), .81 percent for partnerships, and only .12 percent for employment tax returns. Yet each of these groups account for a significant part of the tax gap.

IRS recently identified employment taxes as a major compliance problem. The Assistant Commissioner for Collection said last month, "The IRS is currently faced with $3.7 billion in delinquent payroll taxes owed by over 338,000 businesses nationwide. These are not income taxes ... these are the dollars employers have withheld from their employees' wages and have either neglected or refused to properly deposit ... use of withheld taxes by cash-short employers is up by 49 percent since 1982." We can expect other compliance challenges of this sort -- overseas tax havens, phony dependency claims and unreported corporate income are examples -- to continue to emerge, and Examination must be prepared to deal with them.

In a survey conducted for IRS in 1984, the public opinion research firm of Yankelovich, Skelly, and White examined taxpayer attitudes toward compliance through 20 focus groups and nationwide in-home interviews with 2,200 persons. The study concluded that taxpayers could be classified into five groups:

1. Strong Complier--22 percent of the filers. Ideologically opposed to all forms and rationales for tax cheating.

2. Silent Majority--23 percent of filers. Follows a middle-of-the-road approach, not strongly opposed to or against compliance but basically do what they think is right.

3. Rationalizers--18 percent of filers. Not actively seeking ways to noncomply but strongly support rationales for not complying.

4. Scramblers--21 percent of filers. Do not think there is a reason to rationalize, and support all the ways one can "beat the system."

5. Strategic Noncompliers--16 percent of filers. Ideologically and philosophically committed to noncompliance.

The results show pretty clearly that there is certainly not a strong bias toward compliance on the part of taxpayers generally, without significant enforcement measures. Interestingly enough, a Wall Street Journal/NBC News poll taken last year found that the public favors tougher tax law enforcement by 72 percent to 24 percent.

Nothing would be more conducive to raising compliance than to increase audit coverage to above two percent. Congress and the Administration have embarked on this course, but must demonstrate a continued willingness to provide the necessary resources. IRS must be able to attract and retain the high-calibre people needed in Examination. Being able to compete for the best accounting graduates, and providing incentives to make the Service an attractive career, are fundamental to ensuring an effective Service. A steady budget course, systematically raising audit coverage each year, will enable IRS to plan better and recruit more efficiently.

IRS has recently issued personal computers to Revenue Agents under the Automated Examination System, and this is a major step forward. However, training on the new computers is barely adequate and provision for additional instruction needs to be made. IRS projects that $58 million in additional revenue will be collected from AES in FY 1988 due to increase Revenue Agent productivity. This revenue will not accrue, in our judgement, unless training is increased. Similarly, $13 billion in additional revenue is projected over the 10-year lifetime of AES, which will cost $1.3 billion over the same period. The cost of better training to make this sizeable investment pay off would be modest and well worth the funds expended. NTEU continues to urge an increased dedication to training in the Service.

Collection

Total accounts receivable grew from $34.4 billion in December 1984 to $55 billion last year -- an increase of 60 percent. IRS has had a serious problem stemming, and even explaining, the rapid rise in this hidden tax gap which is seriously eroding the flow of revenues to the Federal government. To get control of this critical situation, it is imperative that NTEU's recommendation for a minimum of 2,000 additional positions for Collection be adopted.

Revenue Officer caseloads have reached unmanageable levels and have been a matter of continuing concern on NTEU's part -- a concern expressed to management on numerous occasions. NTEU's recommendation for 2,000 additional Revenue Officers would help bring caseloads to a more manageable level and reduce the backlog of taxpayer delinquent accounts.

NTEU remains firmly of the opinion that Revenue Officers should be permitted to exercise sound judgement in entering into settlements that are fair to the taxpayer and fair to the government. Collection Division's management philosophy is often counterproductive, resulting in pressure to achieve the maximum number of case closures, and leaving Revenue Officers insufficient time to work cases properly.

The Subcommittee should take steps to increase the protection of IRS employees -- particularly Revenue Officers -- from assaults, threats and harassment by taxpayers. Assault and threat incidents rose from approximately 400 in 1981 to 988 in 1985, an increase of 147 percent. OF the reported incidents, an average of 50 percent each year are physical assaults.

After examining over 3,000 incidents in the files, a consulting firm retained by IRS, Research Management Associates, concluded that "the potential for injury and harm exists on a daily basis for many IRS employees." Of the IRS personnel involved in incidents, 68 percent were Revenue Officers. More than 77 percent of the assaults, and 79 percent of threats with deadly weapons, were committed against Revenue Officers.

Approximately 40 percent of assaults occurred at taxpayers' residences, 30 percent at taxpayers' place of business, and 17 percent inside IRS offices. Approximately 47 percent of threats were made over the telephone, 32 percent were made at taxpayers' residences, and 19 percent were made in IRS offices.

The most dangerous assignments are related to seizure of property. Twenty-six percent of all incidents occurred when Revenue Officers were involved in this type of enforcement action. Making demand for full payment resulted in the second highest number of incidents, followed by filing of liens and serving of levies.

More than 34 percent of employees involved in incidents had been threatened three or more times during their IRS careers. Twenty-five percent of employees stated they had made changes in their work behavior or personal lives as a result of threat and assault incidents, such as securing unlisted telephone numbers, becoming more cautious, limiting public access to their names and information about their families, and moving.

More than 53 percent of Revenue Officers surveyed said they were at least occasionally afraid for their personal safety on the job, compared to 22 percent for other employees. Only 38 percent of Revenue Officers, and 51 percent of other employees, said they were satisfied with personal safety in IRS offices, and improving building security was the most frequent recommendation made by those surveyed.

Many Collection employees during field interviews estimated that at least one-third of all incidents are not reported, because while the taxpayer grew angry or verbally abusive, the employee doubted he or she was in danger of bodily harm. Some of these unreported incidents involved taxpayers who displayed or brandished deadly weapons.

RMA linked the likelihood of incidents to Revenue Officers being saddled with unmanageable caseloads, frequently more than 100 cases at a time. RMA stated, "If Congress continues to press for increased and more aggressive collection, and intends to increase the number of audits conducted, serious attention must be paid to the likelihood of a decline in individual attention to taxpayer problems, and an increase in threats and assaults against IRS employees who feel they do not have the time to research their cases or arrange for protection when warranted."

RMA also criticized field managers' practice of using quantitative measures to evaluate the performance of Collection Division employees. It stated, "Because of the frequency with which this issue was raised, the significant impact it appears to have on employee morale, and its implications for employee safety if precautions are sacrificed in the interest of meeting quotas, we recommend that IRS administrators ensure that Collection group managers and their supervisors adhere to IRS policy on the use of qualitative measures to evaluate employee performance. We also recommend that management consider tempering the emphasis on maximum productivity with a greater concern for screening potential problem cases."

IRS employees are looking for the government to send a stronger message to the public that offenses against them will not be tolerated, according to the survey. "This message should take the form of a policy of increased arrests and referrals for prosecution of threat and assault offenses," RMA concluded.

The Subcommittee should recommend legislation providing hazardous duty pay for, and treatment of Revenue Officers on a par with other law enforcement officers for retirement purposes. The duties of a Revenue Officer are more dangerous and stressful than many other law enforcement positions. We believe that law enforcement officer retirement for these employees is fully justified.

Appeals and Tax Litigation

The current budget for FY 1988 includes a "tax shelter initiative" to reduce the backlog of cases in Appeals. Under this program, 425 new Appeals Officers were added, bringing the total number to 1,592. The President's budget proposes to hold this level in FY 1989.

With the new resources, case disposals in Appeals will rise to 58,600, a gain of 40 percent Moreover, the average caseload per Appeals Officer will fall from 44 to 35 cases.

The problem is that new case receipts will continue to exceed disposals, because of the large number of unagreed tax shelter cases moving into Appeals from the Examination Division. As a result, the backlog of cases will continue to rise from 56,100 this year to 56,300 in FY 1989.

This problem is much worse in Tax Litigation, where docketed case receipts will exceed closures by more than 12,000 in FY 1989, and the backlog of docketed cases will rise from 96,000 this year to 109,200 in FY 1989.

As of December, 1985, the Examination Division had a record inventory of 413,665 tax shelter cases -- a number that had grown steadily since IRS began examinations of abusive tax shelters in 1981. This backlog emerged despite closure of 505,000 cases during 1981-1985 with assessments totaling $8.2 billion, because 91 percent of the assessments or $7.4 billion, were contested. This caused the buildup of case inventories in Appeals and Tax Litigation. Tax shelter cases comprised 61 percent of the Appealsworkload and 30 percent of Tax Litigation's at the end of 1985.

The backlog of 413,000 tax shelter cases constitutes a 6-7 year workload at the current rate of new case receipts (58,800 annually in Appeals and 65,700 in Tax Litigation), and more cases are being generated. Thus, it is evident that the additional 425 Appeals Officers provided this year will be insufficient to bring the backlog under control. NTEU's proposed budget for IRS would provide 600 additional Appeals Officers to begin reducing the backlog, at a cost of $36 million. We strongly urge adoption of our proposal.

In his budget message, the President stated: "I am proposing the development of a private mediating institution to reduce to backlog of cases before the U.S. Tax Court." This proposal originated in OMB's privitization office, and is now being studied by IRS. Administration spokesmen elaborated that, by allowing taxpayers to take certain cases before private arbitrators, they hoped to reduce the backlog of 74,000 cases pending before the Tax Court and expedite collection of an estimated $20 billion in contested revenues. However, in recent congressional testimony, Chief Judge Samuel Sterrett stated that such a proposal would probably not enhance the court's efforts to reduce the backlog of cases, and he questioned the appropriateness of delegating any aspect of the government's tax collection process to private interests.

The proposal of allowing private arbitrators to serve as hearing examiners for certain matters that would otherwise go to Tax Court has been raised periodically. NTEU believes that the Federal government already possesses all the resources required to institute an effective arbitration process that would be fair to the taxpayer and government, and binding upon both. We suggest that Congress consider, as an alternative , that Appeals Officers be reorganized into a separate division of IRS and allow to hear cases on a final and binding basis, just as Administrative Law Judges operate today. This would be good for the taxpayer and good for IRS because it would assure that competent individuals were hearing and deciding cases. This alternative would be less costly, easier to manage, and would not involve delegation of government power to private parties. Appeals Officers assuming this quasi-judicial role would be empowered to adjudicate the interests of taxpayers and government, as contrasted to their present function of negotiating settlements with taxpayers on behalf of the government.

Taxpayer Service

This year, IRS will be severely tested in implementing the sweeping changes enacted in the Tax Reform Act of 1986. The Act changed 2,000 sections of the Internal Revenue Code and necessitated changes in over 200 forms and instructions. The verdict is still out whether the tax code has been made simpler or more complex, and whether ordinary taxpayers will have the ability to understand the tax law and comply. Given such sweeping changes, a level of negative reaction can be anticipated, and the challenge to IRS is to earn the support of public opinion and prevent negative feelings from becoming widespread.

Taxpayers look to IRS to help them understand the tax law so they can accurately self-assess their tax. It is in large part the diligence and competence of the Taxpayer Service representatives that sustains the willingness and ability of taxpayers to voluntarily comply. Recognizing this, IRS had added 1,000 tax assistors and 900 new lines to its toll-free telephone system this year.

IRS is moving to automate taxpayer services through computerized access to taxpayer account information and a data base for researching answers to tax law questions. Without a doubt, the positions of Taxpayer Service Specialist and Taxpayer Service Representative require knowledge and ability beyond that contemplated when those positions were established, and IRS would be well-served by upgrading these positions to increase the pay and career opportunities of Taxpayer Service employees.

IRS' program for Taxpayer Service in FY 1989, the second year of tax reform, is predicated on fewer taxpayers requesting help in the second year. As a result, IRS anticipates assisting 44 million taxpayers in FY 1989 compared to 46 million this year. What in fact happened is that IRS went to OMB with a request for 1,600 additional positions for Taxpayer Service, but came back with a 30 position cut. As a result, IRS has had to plug the gap with skilled revenue agents, tax auditors, and revenue officers to the tune of 92-staff years, up from 80 staff-years in 1987.

A single year is insufficient for taxpayers to digest all the changes in the tax code. Moreover, we do not know how many inquiries due to unclear notices and correspondence will be received next year, as a result of the tax law changes. Will the confusion IRS has identified on some items, such as state sales taxes, mortgage interest, capital gains, and dependency deductions, be eliminated by next year? We believe the demand for assistance will remain strong.

Accordingly, NTEU recommends that an additional 800 tax assistors be allocated for Taxpayer Service next year, to be utilized in areas of heaviest demand to ensure that 85 percent of the demand can be handled at any one time. The cost of these positions, $24 million, is included in the NTEU recommendation shown in Table 5.

In its quality control surveys during the current filing season, IRS found that tax assistors gave incorrect answers 25 percent of the time, and this was confirmed by GAO which found an even higher rate of incorrect response. Recognizing the need for accuracy, NTEU has repeatedly urged that this is best obtained by training and career

opportunities which make it attractive for experienced employees to remain in the Service. A quality control system, if implemented, should be conducted with discretion, as it can become a serious morale problem and produce results opposite to those intended.

Service Center Operations

IRS must pay greater heed to quality control in returns processing activity. In recent years, error resolution files were so large that IRS had to change its tolerance levels for clearing up these cases. This didn't reduce the volume of errors, it simply redefined the errors IRS would work to correct. Inadequate quality control and larger error resolution files lead to erroneous notices which cause grief to taxpayers, especially when they continue to receive notices because their reply is tied up in the Correspondence/Adjustment Branch. Last year, an internal IRS memorandum stated that "management review of pipeline correspondence has reflected error rates as high as 40 percent." Such conditions stem from production pressure and failure to take the time to do the job right the first time. Resources are then expended in notice review in an effort to prevent taxpayers from receiving erroneous notices.

In Service Centers, IRS is not performing the quality review required by its own manual. We strongly recommend that IRS apply the needed resources to achieve the quality standards in returns processing activities that are called for by the Internal Revenue Manual. Errors in these activities affect many IRS functions. For example, in a recent GAO review of the Automated Collection System, problems arose with the taxpayer because IRS had posted returns late, posted returns to the wrong account, or made an error in posting information to an account.

The adjustments/correspondence inventory consists of taxpayer correspondence and tax account adjustment requests. The unpostables inventory consists of transactions on magnetic tape that will not post to taxpayer accounts at the National Computer Center. If correspondence and unpostable inventories are not kept at manageable levels, taxpayers will experience delays in getting their inquiries answered and their transactions posted to the master file. This could trigger erroneous notices which go uncorrected because the taxpayer's reply lands in the correspondence backlog.

Service Centers must be capable of adjusting to rapidly shifting workloads. During the current filing season, IRS has been deluged by requests from partnerships and corporations to retain a fiscal year. Taxpayer requests to change accounting methods have also become backlogged. IRS is shifting personnel to handle these inventories.

IRS plans to bring a full state-of-the-art system, known as the Tax System Redesign, on line in FY 1993. TSR is supposed to provide the modern technology needed to carry IRS into the 21st century. In view of the experience with the Service Center Replacement System introduced in 1985, the Subcommittee should closely monitor IRS' ADP program to ensure that further computer acquisitions are properly planned and implemented. It is especially important that training of Service Center personnel be planned for and introduced soon enough to be effective.

In each service center, Tax Examiners are responsible for auditing returns and following up on underreporter notices and discrepancies disclosed by document matching. As these functions have grown, IRS has failed to recognize the complexity of the Tax Examiner position and the skills and knowledge required. The result of undergrading and low pay has been an exodus from these positions. There are almost 1,000 unfilled positions in Andover, Kansas City, and Philadelphia alone. The Philadelphia Service Center has virtually no experienced Tax Examiners. We strongly urge upgrading the pay and skill standards for Tax Examiners to accurately reflect the skills and knowledge required by the position.

Electronic Filing

Electronic filing of tax returns began as a pilot project last year and has been expanded to include more geographical areas and business returns this year. Because costs are reduced for processing, storage and retrieval of paper tax returns, IRS estimates that electronic filing could save the government in excess of $200 million over the next ten years. IRS hopes that eventually one-third of the 110 million individual returns can be filed electronically by the early 1990's.

The electronic filing system transmits return information directly to computers at IRS processing centers over telephone wires from the offices of more than 2,000 participating tax return preparers and service bureaus. The advantage to taxpayers is that refund checks can be received in 3-4 weeks rather than the normal 6-8 weeks. There are also fewer possibilities for error in processing. At present, only taxpayers with refunds due may file electronically, but future technology may make it possible for taxpayers who have a balance due to file electronically also.

Treasury has already announced its intention to seek congressional authority to accept any commercially acceptable funds transfer method, including credit cards, to permit taxpayers and others who owe money to the Federal government to remit funds. OMB has estimated that, by 1991, the volume of annual credit card payments to the Federal government will total 130 million transactions worth $6.5 billion, making it the largest credit card operation in the world.

NTEU has always strongly supported the introduction of new technology, which brings with it the prospect of wider career opportunities, a more humane work place, and more efficient and responsive government. As electronic filing grows, it will unquestionably impact the work force, and NTEU expects to continue the process of negotiating adjustment plans that provide alternative employment and training opportunities within IRS for employees affected by technological change. We also believe that any staff saving from electronic filing should be retained within IRS and redirected to line positions.

Congressional Leadership Required To Improve Work Force Stability and Quality

IRS employees are a dedicated and competent work force. But far too many talented and experienced workers are leaving the Service due to low pay, stressful working conditions, and the lure of attractive careers in the private sector.

Today, IRS is experiencing a brain drain of some of its most talented people. The turnover Service-wide is 11.3 percent each year. As a result, IRS is forced to spend millions to recruit and train new people -- millions that could be better utilized to pay its experienced workers well and provide them attractive careers. A revenue agent, revenue officer, taxpayer service, or computer specialist requires years of professional development. If IRS is unable to produce these professionals in large enough numbers, and if they are being siphoned off to better-paying jobs in the country's accounting firms and corporate tax departments, technical competence in the Service will suffer, the most advanced computer systems will be operated inadequately, taxpayers will not be able to get the quality of service they deserve, and the long-run health of the tax administration system will be undermined.

The causes and consequences of unacceptable turnover and lack of stability in IRS the work force are portrayed in the following statistics.

- Service Centers are having difficulty attracting and retaining experienced employees. Whereas 55 percent of seasonal employees at Service Centers had previous IRS experience in 1984, this number had dropped to 39 percent in 1987. In the past, many seasonal employees would return to the service centers from one year to the next, bringing their experience with them. The percentage of experienced hires in the seasonal work force has been decreasing, however, from 55 percent in 1984 to 35 percent in 1986. At the Austin center, only 9 percent of new hires had prior experience in 1986. In Andover and Atlanta, the figure was 20 percent. Staff inexperience, said GAO, decreases production and increases risk of error. For example, inexperienced code and edit staff in the Philadelphia Service Center processed 16 percent less 1040's per hour than experienced staff, and made 71 percent more errors. IRS is so hard pressed that an error rate of 18 percent or higher was considered acceptable for newly-trained data transcribers in 8 of 10 service centers. GAO concluded: "The benefits from converting seasonals to permanents or from any other steps that might be taken to stabilize the service center work force are critical. Without such stability, IRS will find itself using more and more of its limited resources to avoid and/or correct errors caused by inexperience."

- Only about 45 percent of Service Center workers are permanent employees, even though 58 percent of the jobs are supposed to be permanent positions. GAO testified last year that Treasury had disapproved IRS' proposals to convert more temporary employees to permanent positions. In 1984, Service Centers at Atlanta, Philadelphia, Ogden, Austin, and Andover all had separation rates for their permanent workforce (excluding temporary and seasonal employees) of 9 percent and above. Austin had a 13.3 percent rate, and Andover 17 percent. All Service Centers together had a 9.5 percent separation rate for permanent employees. According to GAO, Service Center officials attribute high turnover to "lack of part-time work and flexible work hours at the centers, job stress due to performance standards, and entry level salaries that were often lower than those offered by local fast food restaurants."

- According to research by Eugene Steurele of the American Enterprise Institute, "IRS has almost no chance of hiring computer science majors out of college." IRS' Recruitment and Turnover Study (1984), found that the entry-level salary in the private sector for computer science majors with no job experience was $23,500, while government entry-level salaries were between $13,903 and $17,221. One IRS computer division had 213 employees, of whom only 4 held advanced degrees in information systems and only one held a bachelor's degree in computer science. At the Philadelphia Service Center, 21 additional computer operators were to be hired for 1986. Well into the filing season, 19 of the operator positions remained unfilled despite continuing efforts to locate competent new hires. Computer programers in IRS Service Centers needed to program the new Sperry computers in 1985 were insufficiently trained and inexperienced in the new COBOL language, resulting in poorly written programs that took inordinately long times to run.

- Turnover among permanent employees in the rest of of IRS is equally high. Regions collectively had an 11.4 percent separation rate in 1984, led by Southeast (12.5 percent), Southwest (14 percent) and Mid-Atlantic (14.6 percent). The average for district offices was 12.3 percent, and in the national office 9.8 percent. The Service-wide average was 11.3 percent.

  For the critical occupations of Revenue Agent, Revenue Officer, and Tax Auditor separation rates are excessive. Average rates Service-wide were 7.4 percent for Revenue Agents, 8.3 percent for Revenue Officers, and 9.3 percent for Tax Auditors in 1984. However, the average rates conceal a much deeper malaise. More experienced employees are leaving the Service than inexperienced employees. An IRS study of Revenue Agent Attrition for FY 1979 showed that voluntary separations in GS-9 through GS-13 were 63 percent of the total number of Revenue Agent quits, while the other 37 percent were in GS-5 through GS-7. The field offices with the highest quit rates of experienced agents were located principally in the Sunbelt states of the Southeast and Southwest. Inadequate salaries and production pressure are important factors in this attrition.

- IRS is increasingly unable to compete with the salary scales of the private sector in attracting college accounting graduates. Delay in passage of appropriations bills also precludes IRS from making firm job offers until late summer or fall, long after the private sector. An IRS study completed in 1981 found that the average starting salary offer to Bachelor's degree candidates in accounting was $16,728. At the 50th percentile, above which 50 percent of the offers were made, the salary offer for graduates with a Bachelor's degree in accounting was $16,800. The starting salary offer at the 10th percentile, above which 90 percent of the offers were made, was $15,000. These figures compared to IRS starting salaries at the time of $12,266 at GS-5 and $15,193 at GS-7 level. The situation is far worse today as Federal pay scales have fallen further behind the private sector.

IRS can do little about the attractive career opportunities that abound for its skilled people in the private sector. But it does have the means, with Congressional assistance, to tackle the two main sources of high turnover: low pay and production pressure.

Congress and the Administration need to address the problem of IRS salary scales being out of line with the private sector in terms of both pay and responsibility. For too long, the Federal government has kept the upper grade of an Internal Revenue Agent at the GS-13 level, despite the tremendous growth in complexity of our tax laws and the degree of accounting sophistication with which returns are prepared. If experienced agents are to be retained, it is essential that the senior grade level for a Revenue Agent be raised to GS-14, and the journeyman level be raised from GS-11 to GS-12. IRS should begin upgrading the positions of Revenue Agent Team Coordinators, who lead teams in conducting major audits, to GS-14 immediately. In addition, we believe that IRS job responsibilities warrant immediate action to effect the following changes:

- Upgrade Revenue Officer positions by raising the journeyman grade level from GS-9 to GS-11, with appropriate higher grades for revenue officers now at the GS-12 level;

- Upgrade Appeals Officer positions to provide remuneration comparable to that received by those with whom they must deliberate;

- Upgrade Tax Auditor positions to GS-11, commensurate with their work responsibilities;

- Upgrade the journeyman grade for Tax Examiners;

- Upgrade to GS-6 the journeyman level for Data Conversion Terminal Operators, Service Center Clerks and Control Clerks, and Group Clerks/Secretaries.

Many of our people with highly developed tax expertise and technical skills would remain in the Service if rewarded with higher pay for their skill level. Practically the only way this can be done today is by advancing the worker into a higher grade, where positions are too few in number to give all qualified employees working at the same skill level additional pay. Advancing to a higher grade frequently means entering managerial ranks, where duties are those of a manager rather than of a skilled technician, resulting in technical expertise of the individual not being utilized as fully as possible. What is needed is a means of recognizing with additional pay the level of technical expertise attained by IRS workers.

Accordingly, we urge Congress to authorize IRS to spend up to $50 million for a pilot program to pay a skill-level differential to employees in critical occupations with high turnover. Such pay for higher skills would be designed to offset the differential between the private sector and IRS with respect to workers with comparable skills, thereby enhancing retention. This concept has nothing to do with performance pay, which is designed to reward superior performance but is beset with serious practical difficulties. It is, as I say, designed to recognize the higher skill levels attained by experienced workers and

required in their jobs, and to reward these skilled employees with a pay differential that would narrow the gap with the private sector and reduce the present drain in critical occupations.

NTEU will work with IRS management to implement this new pay initiative in the same spirit of cooperation that led to the introduction of employee-manager quality councils. Quality councils put groups of employees and managers together throughout the Service to improve quality of the work product and taxpayer satisfaction. When such groups began employment tax problems that were leading to working on erroneous notices to taxpayers, the rate of errors dropped from 16,000 a week to 1,000 after the quality team's 90 recommendations were implemented, according to IRS.

NTEU and IRS need to work together with Congress to extend this success into the important areas of work force recruitment and retention, based on pay scales for skilled employees commensurate with those in the private sector.

IRS Contracting Out (A-76) Studies

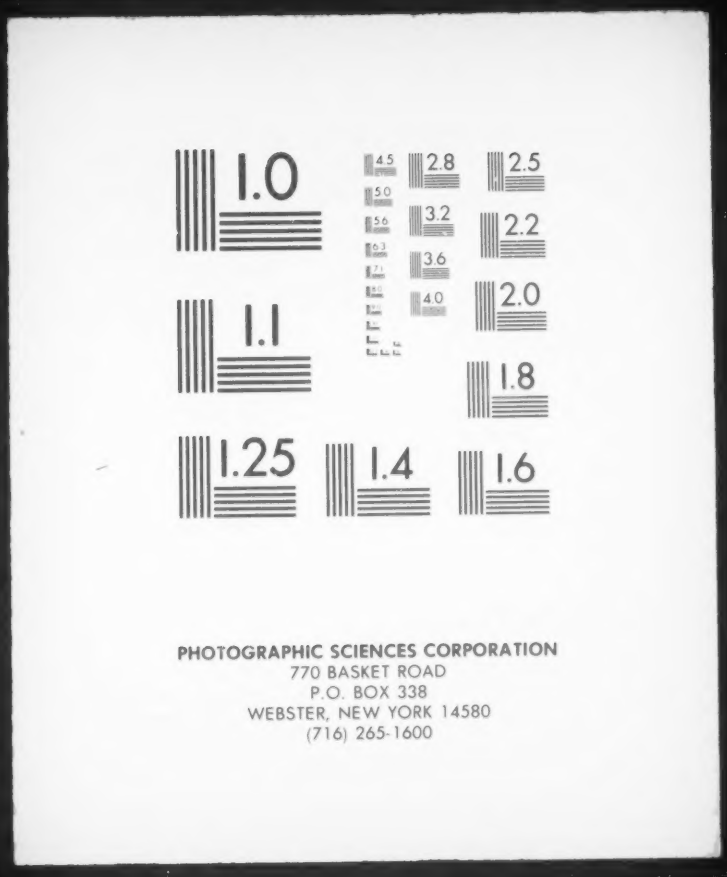
In closing, we wish to call attention to the fact that this budget contains a plan to save $5 million and 587 average positions by contracting out IRS activities to the private sector. IRS is currently making the required A-76 studies, but we are unaware of the activities being looked at.

GAO has reviewed the Administration's contracting out policy, and noted serious problems with it. For one, the definition of the job to be contracted has included only some of the requirements. For another, contractor costs have been underestimated. GAO found that in 9 of 11 contract functions in the Navy, "projected savings were not realized due to higher than estimated contract administration costs and modifications increasing the scope of work."

GAO found that contracting out studies can severely affect employee morale and productivity, creating anxiety that is heightened by the length of time it takes to complete a study. GAO also reviewed the effects on 2,535 employees whose jobs were contracted out in 1985. Of these workers, 74 percent had found other government jobs, with the majority taking positions at lower grades; 7 percent went to work for the contractor; 5 percent were involuntarily separated; and the remainder resigned or retired. Of those who were involuntarily separated, over half said they received unemployment compensation or public assistance. Of those who had gone to work for the contractor, 53 percent said they received lower wages, and most reported that contractor benefits were not as good as government benefits.

NTEU is strongly in favor of making the government more efficient, but evidence shows the contracting out policy is having quite the opposite effect. It is counter-productive, wasteful, and demoralizing. We urge Congress to exclude all Tresury Department functions from the operation of this policy.

Mr. Chairman, this concludes my statement. I will be glad to answer any questions.

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